BROOKINGS

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The Scouting Report: Global Financial Crisis, One Year On

September 15 marked the one-year anniversary of the Lehman Brothers bankruptcy, the largest bankruptcy filing in U.S. history. The Lehman Brothers collapse, combined with the government takeover of Fannie Mae and Freddie Mac, helped trigger the worst financial crisis in the United States since the Great Depression. The impact of the crisis was felt globally, with countries around the world only recently beginning the recovery process.

In this week's edition of the Scouting Report, Douglas Elliott – a former investment banker and current fellow at Brookings – will answer your questions about the financial crisis and where we stand one year later. Fred Barbash, senior editor at *Politico*, will moderate the discussion.

The transcript of this web chat follows.

12:30 Fred Barbash-Moderator: Welcome readers and welcome Douglas Elliott.

12:31 [Comment From Laurie] How close is Congress to tightening the regulations that some say allowed the financial crisis?

12:31 Douglas Elliott: Congress is going to take its time on this one, no matter what they are saying at the moment. It's big, complex, and very heavily lobbied. Equally importantly, there is no political deadline that can't be slipped until we get close to next November's Congressional election.

12:32 Douglas Elliott: I do, however, think we'll get comprehensive reform passed. I don't think there are very many Democratic incumbents who want to be running in November saying: I know that we just went through the worst recession since the Great Depression; I know you know that it was caused by the financial sector; we all know that regulations need to be reformed to prevent another crisis … but we just couldn't get it done.

12:32 Douglas Elliott: The voters won't understand most of the complexity of whatever is passed, but they will want to see something of significance passed. Luckily there is much more consensus about some of the key reforms than you might think reading the coverage, which tends to focus on controversies.

12:32 [Comment From Daniel Lippman (DC)] How do you think the crisis would have been different if Lehman had not been allowed to fail? Niall Ferguson wrote yesterday in FT that it would have been worse, as there would have been no political will in the US for TARP. Also, when should Bernanke hike interest rates?

12:33 Douglas Elliott: There are a variety of views, but I'm with the majority that think we'd be better off if Lehman had been saved. It's true that worse might have come later, but more likely we would have been able to avoid the extreme loss of confidence that rocked the financial system.

12:34 Douglas Elliott: That said, we were always going to go through a fair amount of pain because of the systemic problems that had built up. It's just that I believe the pain would have been somewhat lessened by jumping on Lehman.

12:35 Douglas Elliott: I have a lot of sympathy for the officials who had to make fast decisions in unprecedented circumstances that threatened the onset of a depression. However, I do fault them for not having a solid contingency plan that they were prepared to go with, developed after Bear Stearns and in time for Lehman.

12:35 [Comment From Dave (GWU)] What do you think should be done about the issue of bonuses?

12:35 Douglas Elliott: The bonus question is a tricky one. There's agreement on some of the easy parts. We should force executives who have put a bank in a long-term risk position to earn out their bonuses over a number of years, with the ability to take some or all of it back if things blow up.

12:36 Douglas Elliott: The harder part is figuring out how to measure who has actually put a bank in that position and figuring out how to spread the bonus and what happens if someone leaves a firm, etc.

12:36 Douglas Elliott: The devil really is in the detail

12:37 [Comment From Lester] What do you think about Ben Bernanke saying the recession is over?

12:38 Douglas Elliott: I'm confident he's right, but in the technical sense that he meant it. When an economist talks about a recession ending, he means the economy stops shrinking, not that good times are back. Further, unemployment will certainly get worse for months, as Bernanke also said, even though the total output of the economy is flat or going up a bit.

12:38 [Comment From Brian Beary] At the G20 in Pittsburgh, how likely are we to see another EU-US clash over the size of stimulus spending, like we saw at the Washington summit in November 2008?

12:39 Douglas Elliott: My gut is that this won't be a big issue this time around. There are enough people in the U.S. calling for an end to stimulus that we are closer in view now than we were with Europe. Also, now that the economy is bottoming, there's just less pressure.

12:39 [Comment From David Johnson] What role did currency speculation have in tipping the collapse of Lehman, AIG?

12:39 Douglas Elliott: As far as I can tell, this was a small part of the problem. The much bigger issues were the bets on housing, particularly mortgages and mortgage-backed securities.

12:40 [Comment From Charlie] What do you make of Arnold Kling's recent piece, "Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008," where he points out that the currently proposed remedy - new capital requirements - were the primary problem before. How much have regulators learned from this, and how suspect should we be that they will get it right this time? Ross Levine, et al have also done great work showing that regulators are often plagued by the same inadequacies as bankers. Why should we be more confident this time around?

12:41 Douglas Elliott: We've really only got two choices for institutions that can guide the financial markets: the market participants and the regulators. They are all human and subject to bureaucratic limits (and I include the banks here). The best we can do is to try to use both sides to keep things in balance.

12:41 Douglas Elliott: I am a big believer in higher capital requirements. They are not perfect and they can be gamed, but they do help a lot. One reason that the Brits had to take over their key banks while we intervened in a lesser way is that U.S. banks had higher capital.

12:42 [Comment From Paul] It seems to me that some of the triggers of the US financial crisis were similar to crises seen previously in Asia. Hedge funds, the real estate market, etc. What do you think about this and what do you think about changing the nature and regulation of hedge funds in response to these crises?

12:43 Douglas Elliott: There were similarities with previous crises, but not, I think, the ones you mentioned. Hedge funds were not a big part of this particular crisis. What was common to the crises is that we had a huge expansion of leverage and of risk taking across almost the entirety of society and we had watchdogs who didn't worry enough about the risks.

12:43 Douglas Elliott: I think this stemmed from 25 very good years in the financial markets, running from when the Dow bottomed at 800 in 1982. You'll recall it went up by a factor of almost 20 times after that and other financial markets generally did very well. Most people and institutions learned the lesson that taking risk paid.

12:44 Douglas Elliott: Unfortunately, all this went to an extreme and you had almost everyone taking too many chances and not protecting themselves enough.

12:44 [Comment From Robin] Is there anything banks can do to help bridge the disconnect between "main st." and "wall St."? The class divide in this country is only widening further due to this recession.

12:45 Douglas Elliott: As a former banker, I think the industry is doing a lousy job of showing that they know they were a big part of the problem and that they sincerely want to do a better job. In their defense, it's always hard to say you're sorry when people are screaming obscenities at you. It's a natural human instinct to try to defend yourself.

12:46 Douglas Elliott: It would help if the industry were very clearly supportive of the necessary reforms. They actually are open to them to a surprising extent, but I still think they are resisting some things they should get behind.

12:46 [Comment From Yan] At what point should we draw the line between speculation and irresponsibility or recklessness?

12:47 Douglas Elliott: That touches on a really important issue that is often misunderstood. Anytime someone takes an investment position that isn't tied to some specific risk that they are balancing, you can accuse them of speculating.

12:48 Douglas Elliott: Economists have pretty clearly shown that a fair amount of speculation is necessary to create the liquid markets that help create efficiency. The trick is to appropriate channel and regulate the markets so that speculation does a useful job without creating more harm than good. The U.S. has gotten this fairly right over the decades, but certainly we could have done better in the last few years.

12:48 [Comment From Jay Nargundkar] How has the amount of debt and degree of leverage in the financial system changed from where we were a year ago?

12:49 Douglas Elliott: I don't have good figures, but leverage at financial firms has come down, despite what you may hear sometimes. Even Goldman Sachs, which has been criticized for taking risks, has almost twice as much capital for each unit of risk than it did a year or two ago.

12:49 [Comment From Sally] Has Congress been doing too much or too little?

12:50 Douglas Elliott: Congress moves slowly on big, complex, contentious issues. I think we need to give them some time to work this through. Our Founders designed a government that avoids big errors, for the most part, but doesn't move very fast.

12:51 Douglas Elliott: Luckily, I don't think we are in danger of another major financial crisis for some years. Bankers and other parties may be dumb, but they're not that dumb. Bankers, investors, rating agencies, and regulators really are being a lot more careful right now, for the most part.

12:52 Douglas Elliott: The big risk is that we fail to make the necessary reforms and get an equally bad blow-up in 10 or 15 or 20 years when everyone has gotten very relaxed again and forgotten how bad this can all be.

12:52 [Comment From Ginny] American small businesses see credit and lending shrinking at 1-5% versus previous years, the Banks have pressure by the FED now. Does this mean that even if the recession is over we'll be hit with a hyper-inflation and prices will sky rocket in the next 2 years?

12:53 Douglas Elliott: You're asking one of the central questions. I am in line with the majority of economists in thinking that it has been necessary to put a massive amount of monetary and fiscal stimulus into the economy.

12:54 Douglas Elliott: The Fed has the tools to take it back out over time and will probably get it at least roughly right. However, there is certainly the risk that they won't. Even in that case, I wouldn't expect a hyper-inflation. You have to get things really, really wrong to do that and I just don't see it happening.

12:54 [Comment From David Johnson] What effect did MRKto MRKT regulation have on the collapse?

12:54 Douglas Elliott: My view is that mark to market accounting rules had some impact, but not nearly as much as people sometimes say. For one thing, it works in both good and bad ways.

12:55 Douglas Elliott: The regulation did cause asset prices to decline further by spurring some fire sales by investors who couldn't afford the mark to market volatility. However, it also made people focus on what was going wrong in the housing and financial markets. It is possible that a number of the players would have tried to gut it out and lost even more money over time.

12:55 [Comment From Matthew] I've read in a few places that Goldman was gaming system. Pushing investors into purchasing the bundles of risky mortgages and working to get them prime status while betting their investments against those bundles performing. Is this an accurate assessment? And do you think it's criminal or just questionable?

12:57 Douglas Elliott: Goldman, like all the big financial institutions, has many different parts and they often take positions that differ. Sometimes they are not even legally allowed to coordinate. It does appear that there were contradictions between what different parts were doing, but it is not clear that it was wrong, much less illegal. I don't personally know the details, so I can't venture more of an opinion than that.

12:57 [Comment From Tom] Do you think Obama has the credibility with the business community to successfully push through banking regulations Or will it meet the same corporate opposition as his health care plan?

12:57 Douglas Elliott: I think the politics, and public policy, behind financial reform is quite compelling. The business community needs this as much as the rest of us, even if banks and others fight about certain pieces. I believe compromises will be made and legislation will get through.

12:58 [Comment From Frank] Back to the G-20 meeting - what do you think they will accomplish in Pittsburgh?

12:59 Douglas Elliott: I'm not hopeful that the G-20 meeting will accomplish much at all, besides put out a nice statement or two. However, there is a great deal of underlying cooperation, because there is actually a lot of consensus about many of the necessary steps. So I'm not saying there won't be cooperation. I'm just not sure the G-20 process does much.

12:59 [Comment From Charlie] What do you make of the proposed Consumer Financial Protection Agency? It seems like consolidating regulatory authority is just as likely to make it easier for firms to capture this sort of regulation. The prospect of regulators pre-clearing financial innovations and mandating market provision of specific products also seem worrisome.

1:00 Douglas Elliott: I reluctantly support the Consumer Protection agency. We did such a lousy job of protecting consumers from bad mortgages and credit card gimmicks that I don't think we can leave the regulation with the current regulators.

1:00 Douglas Elliott: I do worry that the agency may be too prone to stop things, even good things, from happening. The Administration put some good language into their proposal to help with that, but there are no guarantees.

1:01 Douglas Elliott: You are right that a single agency could be "captured", but I think it is even more likely that the consumer parts of the various agencies like the Fed could be captured. At least a stand-alone agency would be clearly accountable.

1:02 [Comment From Jay Nargundkar] What is your reaction to the stock market's recent huge gains (S&P500 up 50% since February)? Some foreign markets have performed even better. Do economic forecasts justify this?

1:02 Douglas Elliott: The big thing driving the stock markets was that they went from factoring in a possibility of a depression (not a likelihood, but a possibility) to correctly concluding that it was only a very severe recession and that we would bottom out soon.

1:03 Douglas Elliott: For what it's worth, my gut is that we've overshot and that prices will come down significantly before resuming their upward climb. But, I assure you, I've often been wrong about the market, as has everyone else who ever predicts it. Unless you are an expert, it is best to passively invest your portfolio in a way that makes sense for the long-term, without gambling too much on your own judgment.

1:04 [Comment From Farah Siddique] Do you agree with some observers that the banks that were "too big to fail" are now even bigger (after the crisis) and that their problems have not really been resolved?

1:05 Douglas Elliott: I do agree that the problem of banks that are Too Big to Fail is even worse now. One, the big banks are bigger. Two, we've shown everyone that they will be rescued. I would love to eliminate this problem, but my view is that all of the proposals, like caps on size, would do more economic harm than good.

1:06 Douglas Elliott: I favor the approach of giving the big banks significantly higher capital requirements and some other restrictions, so that they are less likely to fail and less harmful if they do fail. They are essentially operating with an implicit government support, no matter how much we say in the future that we won't rescue them.

1:06 [Comment From Tom] What do you think are the central elements of banking regulation? I haven't seen many concrete recommendations from Brookings. what would you propose?

1:07 Douglas Elliott: Actually, some of my colleagues at Brookings have put together a number of fairly specific proposals, which you can find at www.brookings.edu.

In broad terms I line up with the Administration's proposals. (By the way, I'm a political independent and registered as such, so this is not a partisan reaction.)

1:08 Douglas Elliott: Higher capital requirements are very important, enhanced resolution authority to allow the government to deal with bank holding companies and investment banks like they do with banks is important, and so is doing something about consumer protection.

1:08 Douglas Elliott: There are many other detailed things that need to be dealt with, such as with derivatives, rating agencies, and securitization. But, they're too detailed to go through in this forum.

1:09 [Comment From Jane] What is your view of the Fed? Have they done a good job? Do they need more power?

1:10 Douglas Elliott: Everybody has made mistakes during this last year or longer and the Fed is among them. However, I think that starting last October they got some very important things right. We really did need to do everything in our power to prevent a potential collapse of the financial system and the Fed stepped up to do what it could. David Wessel's book, "In Fed We Trust" does a pretty good job of talking about this.

1:10 [Comment From Brian Beary] Is the TARP money ever going to be used for what it was originally intended for - to buy up the toxic assets?

1:11 Douglas Elliott: A bit of the TARP money may be used for toxic assets, but generally "no". I'm actually okay with that at this point. There was a time when we thought toxic assets were the big problem, but once we headed into a severe recession they became relatively less important than other problems.

1:12 Douglas Elliott: Right now banks are losing money the old-fashioned way, on very plain vanilla loan categories like commercial real estate and credit cards. We'll probably find that 2/3 of the credit losses came from these kind of categories and not from the toxic assets by the time we're done. Further, most of the toxic asset problems have already been absorbed. The new losses that are coming will very largely be from these plain vanilla categories.

1:12 [Comment From Charlie] How will the Administration determine systemic significance? Will they set a clear, general rule (equation, size floor, etc) or will they label certain firms?

1:13 Douglas Elliott: I think it's going to be a fairly subjective call based on a wide variety of factors. I do think the government will formally label firms in that way, although firms may move in and out from time to time.

1:14 Douglas Elliott: That said, I bet you I could name 90% of the firms right now. There's simply no question about most of them, such as Citigroup or J.P. Morgan, so this isn't as tricky in reality as in theory.

1:14 [Comment From Suzie] Any idea on what' s going to happen with Fannie and Freddie? What do you think will happen with their public/private status?

1:15 Douglas Elliott: It's going to be awhile before we know what will be done with Fannie and Freddie. My best guess is that they will be put back in the private sector, but with heavy limitations that make them more like the old-style utilities. I don't think they'll go back out as they were, because it wasn't a good system and we've seen it blow up.

1:15 Douglas Elliott: There's some chance the government will just keep Fannie and Freddie, eliminating the shareholders either by buying them out or wiping them out. However, my gut is that they'll be back in the private sector.

1:16 [Comment From Pavis] Do you share the same view with many economists who suggest that global financial stability cannot be achieved unless China spend more and save less?

1:17 Douglas Elliott: I'm not sure I'd say it couldn't be achieved without those changes in China, but it would certainly be very helpful if they happened. It's inevitable that it will at some point -- the balance is not sustainable in the long run. Doing it sooner would be better for at least the rest of the world and probably China.

1:17 [Comment From Alison] How do you think China will behave vis-a-vis the massive ownership of US currency?

1:18 Douglas Elliott: China's massive reserves of U.S. dollars represent a big potential problem for both them and us. However, the Chinese have a big incentive not to destroy the value of the dollar, since they own so many of them. Also, a big dollar decline would make China much less competitive against our products.

1:18 Douglas Elliott: So I suspect we'll muddle through, although there will be a number of very scary moments.

1:18 [Comment From Suzie] You're a former investment banker, any free tips? What should I be putting money into? Other than retirement, of course.

1:19 Douglas Elliott: You may hate the reply, but the big key is saving money, not so much how you invest it once it's saved.

The best investments depend heavily on your particular financial situation and risk appetite. I'd suggest being somewhat cautious right now about the stock market, but I'm not sure I have anything else useful to say.

1:20 [Comment From Kenneth] I'm pretty sure that I read that Congress was trying to get the Fed to disclose all the money they're pumping in to the system (outside of TARP). Are they making any headway on getting transparency?

1:21 Douglas Elliott: I think the Fed has been pretty open about the total levels of activity of different types. The fights have been about revealing the specific names of their counterparties on certain of the programs where the Fed is afraid that public disclosure would cause a panic. (Borrowing from the Fed in large size can be seen as a sign of weakness.)

1:21 [Comment From Alison] How long can central banks keep interest rates low?

1:22 Douglas Elliott: That's another great question. Rates will start rising when investors decide the economies around the world are picking up on a sustainable basis. We don't know when that will be. Until that happens, keeping the money in government bonds at low interest rates will remain attractive.

1:22 [Comment From Helen] What bad habits will bankers need to give up so we can move forward?

1:23 Douglas Elliott: Banks clearly need to find a way to deal with compensation that is fair and does not encourage excessive risk. So, one bad habit would simply be to let inertia keep the system in place just the way it is.

1:24 Douglas Elliott: Another bad habit was to be sloppy about risks. I suspect that has largely vanished as everyone got scared, but there may still be pockets of that bad habit out there. Certainly we need to worry that it might come back after things are better for awhile.

1:25 Fred Barbash: That's all we have time for today. Thanks everyone for your great questions - sorry we didn't get to all of them. And thank you Doug for your thoughtful answers.

1:25 Fred Barbash: Please join us next week - same time, same place - for a chat with Colin Bradford on the upcoming G-20 Summit.