Explanations of the Financial Meltdown and the Present Recession

MAURICE MULLARD

The present economic crisis started in June 2007 and is still unfolding with high rates of unemployment, an ongoing banking crisis in the euro zone, large public sector deficits in many of the advanced economies and unresolved problems of global trade imbalances. Explanations of the crisis are contestable, reflecting competing discourses and narratives. The languages that define each of these narratives are incommensurate in the sense that they offer competing views of the world, with little room for agreement as to causes and what needs to be done:

To say that a particular network of concepts is contestable is to say that the standard and criteria of judgement it expresses are open to contestation. To say that such a network is essentially contestable is to contend that the universal criteria of reason, as we can understand them, do not suffice to settle these contests.¹

In a debate launched in the pages of the Financial Times during July 2010, Wolf pointed to the fierce debate on the themes of austerity and stimulus between market liberal ‘cutters’ and Keynesian ‘postponers’.² Ferguson and Taylor favoured immediate reductions in public expenditure.³

The evidence is very clear from surveys on both sides of the Atlantic. People are nervous of world war-sized deficits when there isn’t a war to justify them. The remedy for such fears must be the kind of policy regime-change . . . which the Thatcher and Reagan governments successfully implemented. Then, as today, the choice was not between stimulus and austerity. It was between policies that boost private-sector confidence and those that kill it.⁴

Ferguson’s plea was a return to the Reagan–Thatcher Revolutions despite the fact that under Reagan deficits had exploded to finance defence spending and the Thatcher government had actually failed to reduce public expenditure as a ratio of GDP. Even after all the privatisations, public expenditure was higher in 1992 then when the Thatcher government took office in 1979.⁵

On the other side of the debate, the (postponers) stimulus sympathisers included De Long; Skidelsky and Kennedy; and Summers pointed out that while the deficit was a problem, in the context of recession there was a problem of demand, which had been caused by major declines in household net worth.⁶ Households had responded to the financial meltdown by increasing their savings and paying off debt. In the context of falling aggregate demand, the government was the consumer of last resort:

[W]here an economy’s level of output is constrained by demand and the central bank has at best a limited ability to relax that constraint because it cannot reduce interest rates to below zero, fiscal policy can have a significant impact on output and employment. Through either direct spending or tax cuts that promote private spending, hiring or investment, governments possess a range of tools to raise demand directly. As increased demand boosts incomes, these measures raise output further. The result will be economic growth and reduced joblessness. To the extent that expansionary fiscal policies affect growth, their impact on future indebtedness is attenu-
ated as tax collections rise, transfer payments fall, and the ability of the economy to support debt increases.7

Wolf pointed out that no one was really sure as to which narrative was right and that people needed to make up their own minds. However, the debate was important because policy makers have proceeded to construct public policies that approximated to the specific discourse they favoured, and therefore the outcomes of their policy choices would soon unfold as the economy assimilated to the policy changes. The question for the policy makers was whether their course of favoured treatment would have adverse effects and what contingency policies did they have to deal with such adverse effects:

To tighten or not to tighten that is the question. This is the issue addressed in the Financial Times this week, echoing the fierce debates of the 1930s. . . . Readers must make up their own minds on the merits of the arguments this week. . . . My own strong sympathies are with the postponers. But on one thing everybody agrees, this debate matters. We cannot be sure who is right. But we can be sure if policymakers get it wrong the results may well be dire. Physicians must prepare to respond swiftly to adverse reactions to their favoured course of treatment.8

The United Kingdom’s Coalition government has planned to reduce deficits by £80 billion during this Parliament. Public sector deficits are perceived as crowding out the private sector through high interest and employing resources that could be used more productively in the private sector. This argument is central to the government’s case despite countervailing evidence that show interest rates as close to zero and the Treasury bill with yields of below 3 per cent, and no evidence that the financial markets have lost confidence in Britain. Equally, the most recent Office for Budget Responsibility (OBR) forecast shows unemployment and low growth persisting to 2015.

In the following sections it will be suggested that there are three major areas of contestability. These include the role of government and disagreements about whether government policies succeeded in stabilising financial markets or whether the government through intervention undermined the workings of markets which in turn resulted in increased uncertainty. The second area of contestability is the question as to whether the recession was inevitable, which suggests that this was an exogenous event that was difficult to forecast, or whether it was unavoidable since it represented the outcome of a series of policy decisions which eventually result in bubbles in housing and financial markets. The third area relates to problems of ideas and ideals and to what extent the paradigm of markets influenced a series of policy of de-regulation and the role ideas played in the financial crisis. It will also be argued that the process of contestability creates the possibility of locating explanations of the financial crisis under five categories (see Figure 1). These include: Pragmatist; Market Liberal Fundamentalist; Institutionalist; Keynesian Collectivist; and Structuralist.

Contestable Terrain One: the role of government

The responses of governments to the crisis included partial nationalisation of banks exchanging equity for asset-backed securities providing guarantees on loans and the purchase of assets. The International Monetary Fund (IMF) calculates that the global cost of the bail-outs was around US$16 trillion. The American Government under the Troubled Asset Relief Program (TARP) provided US$700 billion to deal with the problems of capital and liquidity requirement in the banking sector. Starting with the collapse in house prices in June 2007, the bail-out of Bear Stearns in March 2008, the bankruptcy of Lehman in...
Figure 1: Map of explanations of recessions

September 2008, followed shortly by the rescue of AIG a few days later, economies seemed to be falling off a cliff. With the real threat of contagion spilling over to other investment banks, there was an increased possibility that the fragile financial markets would also effect collapse of major industries because of the freezing up of asset backed commercial paper. Also at risk were the pension and savings of millions of households. The primacy of government was therefore the need to stabilise financial markets to provide the necessary guarantees and to stop major runs on the banking sector.

In the United Kingdom, the Gordon Brown’s Labour government took partial ownership of Northern Rock, Lloyds and Bank of Scotland, while in the United States, Secretary Paulson and Federal Reserve Chairman Bernanke put together a US$700 billion programme to stabilise America’s financial markets. Paulson, in his recent memoirs, argued that his rescue package ran against the prevailing ideology of the Republican party and that he had to negotiate the rescue through the leadership of the Democrats. There is major disagreement about the role of government. The area of concern is whether government intervention did stabilise the financial markets and avoided a depression similar to the Great Depression of 1929 or whether the bail-outs actually reinforced a climate of moral hazard, which then allowed financial institutions to sustain their high levels of leverage without seeking to improve their liquidity or capital margins.

The Pragmatist interpretation

The Pragmatist interpretation is a time-related series of accounts that reflect the immediacy of the crisis. The Pragmatists’ major concern was trying to make sense of the crisis while it was still unfolding. Those policy makers directly involved in the process of seeking to stabilise the financial markets did not have the benefit of hindsight, but at the time were trying to create order from disorder. The responses of Secretary to the Treasury Paulson, Chairman Bernanke of the Federal Reserve and the New York Federal Reserve Chairman Geithner were piecemeal, but in the end the measures seemed to work as the financial system did return to some form of stability. Wessel has called these pragmatists ‘the four musketeers’, who within a period of two weeks between them changed the landscape of the American financial sector through forced mergers of investment banks, making Morgan Stanley and Goldman Sachs bank holding companies.

In a recent article in the New York Times, Warren Buffet praised the role of the Government in stabilising the economy:

Just over two years ago, in September 2008, our country faced an economic meltdown. . . . One of Wall Street’s giant investment banks had gone bankrupt . . . A.I.G., the world’s most famous insurer, was at death’s door. Indeed, all of corporate America’s dominoes were lined up, ready to topple at lightning speed: 300 million Americans were in the domino line as well. Well, Uncle Sam, you delivered. . . . I would like to commend a few of your troops. In the darkest of days, Ben Bernanke, Hank Paulson, Tim Geithner and Sheila Bair grasped the gravity of the situation and acted with courage and dispatch.

In the immediate aftermath of 2007, a window of opportunity seemed to open at least for a short while of an emerging consensus of readiness to accept that the de-regulatory environment in financial markets and the lack of oversight by regulators had contributed to the crisis. The shift from an originate-and-hold model of banking to an originate-and-distribute one had resulted in a moral deficit, with markets participants including bankers, lawyers brokers and households pursuing short-term gains in fees and high levels of compensation that in the long term proved to be unsustainable.
In 2007 those policy makers who favoured improved regulation of the securisation process to put these instruments on clearing platforms and make these derivatives more transparent seemed to be in ascendance. Within this framework, the expansion of a derivatives market that was unregulated—especially the emergence of credit default swaps—was accepted as being a major contributor to the financial crisis.13

As the notional value of CDS went from slightly less than $10 trillion in 2004 to roughly $60 trillion at the end of 2007, mortgage-backed securities (MBS) went from roughly $1.5 trillion in 2004 to its peak of $3.5 trillion in 2007 before both started a decline. The simultaneous rise and fall of the CDS market and the MBS market reflects the interplay between weak rating agency practices with respect to CDOs, reliance on CDS protection of CDOs by AIG. Ultimately each of these factors helped feed into the housing bubble. Once the housing bubble burst in 2007, mortgage securitization collapsed, the demand for CDS protection proportionately decreased and the writers of CDS, like AIG, started suffering significant losses.14

There seemed to be agreement that the regulatory system was broken and that markets could be improved through better regulation. Policies on bank regulation, control of leverage and increased capital requirements did not create much controversy about the future shape of policy reform. Both the CEOs of Goldman Sachs and JP Morgan, in giving evidence to the Financial Crisis Inquiry Commission (FCIC) enquiry in January 2010, supported the proposal to regulate the previously unregulated derivatives markets, with the CEO of Goldman Sachs making the case for central clearing:

With respect to OTC derivatives, Goldman Sachs supports the broad move to central clearinghouses and exchange trading of standardized derivatives. A central clearinghouse with strong operational and financial integrity will reduce bi-lateral credit risk, increase liquidity and enhance the level of transparency through enforced margin requirements and verified and recorded trades. This will do more to enhance price discovery and reduce systemic risk than perhaps any specific rule or regulation.15

Dimon in his testimony pointed to the process of securisation and how the shift to an originate and distribute model in banking had resulted in poor underwriting standard for mortgage borrowing. He also pointed to problems of predatory lending and the dishonesty of mortgage brokers:

As the housing bubble grew, new and poorly underwritten mortgage products helped fuel asset appreciation, excessive speculation and far higher credit losses. Mortgage securitization had two major flaws that added risk: nobody along the chain had ultimate responsibility for the results of the underwriting for many securitizations, and the poorly constructed tranches converted a large portion of poorly underwritten loans into Triple A-rated securities. In hindsight, it’s apparent that excess speculation and dishonesty on the part of both brokers and consumers further contributed to the problem.16

The Pragmatists central argument was that the incoming Obama administration had to focus on a series of regulatory reforms to prevent future financial meltdowns. Advocates for regulatory reform urged the new administration to create a Consumer Protection Agency to deal with future predatory lending and to ensure that households were sold mortgages they could understand and were transparent. Regulators, including Gensler at the CFTC and Dinallo in New York, all argued that the unregulated derivatives markets had to be standardised and put on exchange and trading platforms that had transparent prices similar to clearing and trading on the stock exchange, which shows daily price movements. James Dimon giving evidence to the FCIC confirmed that 80 per cent of the so-called ‘over the counter’ customised derivatives could be standardised and put on clearing platforms.
When the crisis hit and huge swaths of the American financial system got caught in the run on the parallel banking system, many came running to the Federal Reserve for liquidity and for protection. The emergency financial response to the run that started in the parallel financial system was necessary to protect our economy from an even greater calamity. But if our regulatory and supervisory systems had had the tools and authorities to prevent risks from accumulating in unregulated sectors of the financials system in the first place, such a large emergency response would not have been necessary. That is a key reason why financial reform is so essential.  

The Market Fundamentalists

Within this temporal framework, as the banks stabilised and the panic seemed to recede there was an ascending literature that sought to criticise the measures that were taken during the immediacy of the crisis. The second series of explanations came from those whose starting points were existing theoretical frameworks and who sought in turn to fit the events of 2007 within these existing models. They can be categorised as Market Fundamentalists. Within this category are Wallison, and writers for the CATO Institute such as Schwarz, Taylor, Kyle, and Kohlhagen, whose common theme was that government intervention was the major contributor to the crisis, including the misguided policies to bailout the banks, TARP, attempts to regenerate the economy through stimulus measures and high public sector deficits. This approach has a number of layers that includes government housing policy, the policy of low interest rates, the subsidies to government-sponsored agencies (GSEs) including Fannie Mae and Freddie Mac, moral hazard and the bail-out of Bear Stearns.

Taylor blames the meltdown on the government undermining his ‘Taylor Rule’—namely of fixing the interest rate in relation to an inflation rate. The focus is the Federal Reserve and interest rate policy followed by Alan Greenspan. The argument is that Greenspan kept interest rates too low for too long, which in turn contributed to the housing bubble. Furthermore, the Federal Reserve misdiagnosed the crisis by arguing that the problem of the banks was one of liquidity with the decision by the government to purchase mortgage-backed securities through TARP:

I have provided empirical evidence that government actions and interventions caused, prolonged, and worsened the financial crisis. They caused it by deviating from historical precedents and principles for setting interest rates, which had worked well for 20 years. They prolonged it by misdiagnosing the problems in the bank credit markets and thereby responding inappropriately by focusing on liquidity rather than risk.

Other market fundamentalists have pointed to the Clinton/Bush administrations housing policy aimed to encourage wider home ownership, including tax deductions on mortgages, and Freddie Mac and Fannie Mae for their monopoly position in the housing market. Providing targets for Fannie Mae and Freddie Mac created increased risk in mortgage-backed securities. The policy of low interest rates created by Greenspan in 2003 meant that low interest fed into the housing bubble because of expectations that interest rates would remain low, which in turn encouraged people to take on more debt.

In the case of the housing price boom, the government played a role in stimulating demand for houses by proselytising the benefits of home ownership for the well-being of individuals and families. Congress was also more than a bit player in this campaign. Beginning in 1992, Congress pushed Fannie Mae and Freddie Mac to increase their purchases of mortgages going to low- and moderate-income borrowers. In 1996, HUD (Department of Housing and Urban
Development) gave Fannie and Freddie an explicit target: 42 per cent of their mortgage financing had to go to borrowers with incomes below the median in their area. The target increased to 50 per cent in 2000, and 52 per cent in 2005.21

According to market fundamentalist, therefore, there was no problem with derivatives or credit default swaps. Derivatives confirm that markets are working and reduce the costs for business, while credit default swaps provide accurate pricing mechanisms. Rational expectation and efficient markets models of the economy do not need to be revised or questioned.

Credit default swaps (CDSs) have been identified in media accounts and by various commentators as sources of risk for the institutions that use them, as potential contributors to systemic risk, and as the underlying reason for the bailouts of Bear Stearns and AIG. These assessments are seriously wide of the mark. They seem to reflect a misunderstanding of how CDSs work and how they contribute to risk management by banks and other intermediaries. In addition, the vigorous market that currently exists for CDSs is a significant source of market-based judgments on the credit conditions of large numbers of companies. Although the CDS market can be improved, excessive restrictions on it would create considerably more risk than it would eliminate.22

Government intervention, including bail-out of banks, created a chemistry of moral hazard with financial institutions coming to the conclusion that they were too big to fail. In an open letter to Chairman Ben Bernanke, a series of commentators criticised the Federal Reserve for continuing to intervene in the economy through quantitative easing:

We believe the Federal Reserve’s large-scale asset purchase plan (so-called ‘quantitative easing’) should be reconsidered and discontinued. We do not believe such a plan is necessary or advisable under current circumstances. The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed’s objective of promoting employment.23

The important issues in this quote were the twin references to inflation and employment. Despite the counter evidence that the American economy had contracted by around 5 per cent of GDP, as well as evidence of access capacity, the concern of these commentators was that the Federal Reserve was likely to cause inflation through monetary easing. The implicit argument rested on the market theory that government was crowding out the private sector. Second, their argument was that employment should not be the concern of the Federal Reserve. Unemployment will be resolved within the dynamics of labour markets, which again implied that unemployment was voluntary and that the unemployed had a preference for leisure as they waited for times of better wages.

Contestable Terrain Two: problems of interpretation inevitability as against policy choice

The second layer has been the disagreement of interpretation as to whether the financial crisis was either an event that was difficult to predict or was the product of the policy process. Was the financial crisis an exogenous event and governments had to respond to the external challenge, or was it endogenous, caused by a series of policy choices? The sudden declines in house prices were accompanied by the Rating Agencies downgrading asset-backed securities from triple AAA to below investment grade, which led to increased uncertainty in financial markets with investment banks finding themselves under pressure to provide additional collateral in the repossessions (REPO) markets and the eventual freezing up of interbank lending.
The Institutionalists

Some CEOs at the major investment banks—including Fuld, who was the CEO of Lehman, and Cayne, CEO of Bear Stearns—made the case that no one was able to anticipate the magnitude of the financial crisis. Since bubbles were difficult to predict or regulate, markets needed to be left alone so economies could very quickly recover from such disruptions. The common theme response was to adopt the Minsky moment—the view of the crisis as being a series of inevitable stages leading from caution to stability and that stability in itself would lead to euphoria, irrational exuberance and eventual bubbles. Al Greenspan, the previous chairman of the Federal Reserve, in his testimony to the FCIC in 9 March 2010, pointed out that attempts to crush bubbles through higher interest rates would cause more damage to the economy than allowing bubbles to burst and governments providing a safety net for those lost jobs in the immediate period of such a disruption:

At some rate, monetary policy can crush any bubble. If not 6½%, try 20%, or 50% for that matter. Any bubble can be crushed, but the state of prosperity will be an inevitable victim. Unless there is a societal choice to abandon dynamic markets and leverage for some form of central planning, I fear that preventing bubbles will in the end turn out to be infeasible. Assuaging their aftermath seems the best we can hope for. Policies, both private and public, should focus on ameliorating the extent of deprivation and hardship caused by deflationary crises.

The counter argument was to see the financial crisis as human-made. The financial crisis was therefore not an exogenous factor, but rather the outcome of a series of policy choices. Johnson’s central argument was that the financial sector has had a major influence on the policy process in America. The finance industry in the United States has gained prominence because of what Johnson calls ‘cultural capital as a belief system’. The financial sector over the past two decades had grown from 4 per cent of GDP to 9 per cent, and its contribution to corporate profits have increased from 16 to 40 per cent:

[T]hese various policies—lightweight regulation, cheap money, the unwritten Chinese–American economic alliance, the promotion of homeownership—had something in common. They all benefited the financial sector. Policy changes that might have forestalled the crisis but would have limited the financial sector’s profits—such as Brooksley Born’s now-famous attempts to regulate credit-default swaps at the Commodity Futures Trading Commission, in 1998—were ignored or swept aside.

Rheihart and Rogoff, in their historical studies of financial crisis, have pointed out that most crises start in the banking or housing sector where bubbles are formed because of high leverage and increased risk exposure. They associate the financial with the policy of liberalisation and deregulation in financial markets that started with the years of President Reagan in the United States and Prime Minister Thatcher in Britain, where both governments committed themselves to de-regulation and a retreat of the state. The repeal of the Glass Steagall Act in 1999 and the Commodities Futures Modernization Act (CFMA) were policies that created the climate of deregulation:

While each financial crisis no doubt is distinct, they also share striking similarities in the run-up of asset prices, in debt accumulation, in growth patterns, and in current account deficits. The majority of historical crises are preceded by financial liberalization. While in the case of the United States, there has been no striking de jure liberalization, there certainly has been a de facto liberalization. New unregulated, or lightly regulated, financial entities have come to play a much larger role in the financial system, undoubtedly enhancing stability against some kinds of shocks, but possibly increasing vulnerabilities against others.
CFMA legitimised a process where new financial instruments such as over the counter derivatives did not have to be traded in exchanges with transparent price movements; instead, the new derivatives became customised where each transaction was unique. Unregulated markets for mortgage-backed securities (MBS), collateralised debt obligations (CDOs) and credit default swaps (CDS) contributed to the financial crisis because of their lack of transparency, the uncertainty of counterparty exposure and the absence of posting of collateral. AIG is seen as the major example of having sold a series of credit default swaps that at one level generated streams of income for the company in the short term and could be defined as profits without AIG having to post collateral. When these insured bonds were downgraded in July 2007 and AIG was asked to post collateral by Goldman Sachs, the company very quickly lost liquidity and its triple AAA ratings. The American government eventually had to step in and meet the CDS contract of AIG at a total cost of US$180 billion; AIG sold approximately US$400 billion of insurance without having to post collateral.

The unregulated marketplace in credit derivatives was a central cause of a near systemic collapse of our financial system. Credit default swaps played a major role in the financial problems at AIG, Bear Stearns, Lehman and the bond insurance companies. A major cause of our current financial crisis is not the effectiveness of current regulation, but what we chose not to regulate. This lack of regulation has been devastating for thousands of New Yorkers and every taxpayer in the United States. We must see that this does not happen again. Credit default swaps must be regulated and sellers must be required to hold sufficient capital. That will make them more expensive, but it will mean the guarantee has real value.30

The Institutionalist arguments seek to put the emphasis on the limits of the shadow banking system and their reliance on short-term unsecured funding in the REPO markets, which in turn evolved into banks runs similar to those of the 1880s and early 1900s.31 The failure of government regulators was to oversee the growth on bank holding companies, leverage and capital requirement. Gorton points out that financial crisis of 2007 was similar to that of 1907 when depositors demanded their money back; this time the panic started in the shadow banking sector with the depositors, the REPO markets, not rolling over the debt of investment and demanding larger haircuts on collateral:

The key question for understanding the panic is: Why were non-subprime-related asset classes affected? Subprime mortgage originations in 2005 and 2006 totalled about $1.2 trillion . . . , a large number to be sure, but not large enough to cause a systemic crisis. How was the shock turned into a panic? Uncertain about the solvency of counterparties, repo depositors became concerned that the collateral bonds might not be liquid; if all firms wanted to hold cash—a flight to quality—then collateral would have to decline in price to find buyers. The run on repo is, again, akin to previous panics. ‘Withdrawal’ corresponds to an increase in haircuts.32

The regulatory system had allowed for regulator arbitrage as financial institutions sought to be regulated by a principal regulator that did not have the capacity or expertise to oversee highly complex institutions. Bank risk management in the finance industry, the brokers who sold sub-prime mortgages, and the rating agencies and their models in the rating of triple AAA asset-backed securities in exchange for higher fees have all been described as broken systems that needed to be reformed.

Compounding the problems at these financial institutions was a financial regulatory system that was archaic and outmoded. Our regulatory framework was built at a different time for a different system, and it has not kept pace with the rapid changes in the financial industry. I noted during my time at Treasury the enormous gaps in authority, duplication of
responsibility, and unhealthy jurisdictional competition. No single regulator had responsibility for overseeing the stability of the system. The result was that regulators were often unable to supervise the firms they oversaw adequately, they did not see the impending systemic problems that progressed towards a crisis, and they did not have the tools to contain all the harms that unfolded as institutions began to collapse.\textsuperscript{33}

Bernanke attempted to separate out the differences between what he called ‘triggers’ and structural explanations of the recession. His major theme was that the decline in house prices and sub-prime loans were in the category of trigger explanations in the sense that their impact on financial losses totalled between US$500 billion and US$1 trillion, and that a global economy of US$65 trillion should have been able to absorb these loses without creating the major global financial crisis of 2007. The IMF has forecasted that total government bailouts have amounted to approximately US$16 trillion. In the United States, household net worth has decline by US$12 trillion, while homeowners have seen something like US$6 trillion wiped from their home ownership equity.

With more than $1 trillion in subprime mortgages outstanding, the potential for losses on these loans was large in absolute terms; however, judged in relation to the size of global financial markets, prospective subprime losses were clearly not large enough on their own to account for the magnitude of the crisis. (Indeed, daily movements in global equity markets not infrequently impose aggregate gains or losses equal to or greater than all the subprime mortgage losses incurred thus far.) Rather, the system’s vulnerabilities, together with gaps in the government’s crisis-response toolkit, were the principal explanations of why the crisis was so severe and had such devastating effects on the broader economy.\textsuperscript{34}

Bernanke argues that the structural weaknesses were related to changes in the financial markets. These changes included the increased reliance of investment banks Bear Stearns, Lehman, Merrill Lynch and Goldman Sachs on short-term unsecured financing through the REPO markets, and mutual funds that supplied funding to the banks on very short-term loans. Once the mutual funds lost confidence in collateral deposited, they asked for increased margins, which in turn put pressure on investment banks to sell assets in a market with no demand for these asset-backed securities. This made it difficult for the banks to price these securities, which meant that they had to rely on computerised models. Bernanke agrees with the Gorton thesis that there was run on the shadow banking sector:

\textbf{[T]he reliance of shadow banks on short-term uninsured funds made them subject to runs, much as commercial banks and thrift institutions had been exposed to runs prior to the creation of deposit insurance. A run on an individual entity may start with rumours about its solvency, but even when investors know the rumours are unfounded, it may be in their individual interests to join the run, as few entities can remain solvent if their assets must be sold at fire-sale prices.}\textsuperscript{35}

In a presentation during 2008, Blinder pointed to what he called ‘the ten possible culprits’ that could be associated with the financial meltdown of 2007 and the ongoing economic crisis.\textsuperscript{36} The list of culprits included:

- Culprits Number 1 were the ‘Masters of the Universe’ and included the bond markets where in the midst of low interest and low yield on safe assets in 2003, went in search of higher yield securities and were willing to increase their leverage as a means of increasing performance but also increasing risk.
- Culprits Number 2 pointed to Americans and the assumptions they made that house prices would continue to rise. The irrational exuberance of increases in house prices resulted in
more households taking out equity on their homes to meet personal consumption. The sub-prime mortgages, including adjustable mortgages, put these households at risk. Householders lost approximately US$6 trillion dollars of equity in their homes.

- Culprits Number 3 were the mortgages lenders, including brokers who sold mortgages to consumers; sub-prime mortgages yield high interest but also higher fees. Non-document loans (so-called ‘liar loans’) and NINJA (No Income No Job and No Assets) loans were generated by brokers who knew that these high risk mortgages will be sent down to the pipeline to investment banks to be securitised. Underwriting standards were undermined in a world of high fees and high compensation for the brokers.

- Culprits Number 4 were the bank regulators who failed in supervising investment banks. Regulators were aware of an ascending ideology of deregulation and leaving the market to itself. Regulatory arbitrage meant that banks went in search of principle regulators that pledged a lighter touch. Some of the these principle regulators had neither the capacity nor the necessary expertise to supervise complex bank holding companies.

- Culprits Number 5 were private labelled mortgages. The expansion of derivatives, the securisation of mortgages into MBS and the creation of Credit Debt Obligations (CDOs) and the CDS (Credit Default Swaps) market were not regulated. It is estimated that the notional value for over the counter derivatives (OTC) increased to US$650 trillion in a global economy of US$65 trillion, while the market for CDS increased to US$60 trillion—about four times the size of the American economy. As the financial meltdown became clearer, it was the investment banks that were left holding the majority of these securities. As asset prices declined and banks had to price these securities to market value they were forced to write down a large amount of their assets, which in turn shrunk their capital ratios assets.

- Culprits Number 6 were the rating agencies that rated mortgage-backed and other asset-backed securities as triple AAA and yet within a few months these securities were downgraded below investment grade. The issuer pay created a conflict of interest problem with the credit rating agency (CRA) reluctant to refuse to rate a bond since the issuers could always go to another a competing agency to get a rating. The business model created by the CRA undermined their commitment to objectivity and impartiality in the ratings process.

- Culprit Number 7 was the securisation process. The unregulated market of over the counter derivatives made it difficult to discover the connections between counter parties. AIG’s selling of CDS to banks without laying out collateral meant that the cost of insurance was under-priced and the lack of transparency created problems of price discovery. The problems faced by Bear Stearns and Lehman confirmed their precarious position in depending on short-term lending in the REPO markets. These arguments were countered by those who point out that the derivatives and CDS market actually contributed to economic prosperity. Derivatives reduced the cost of companies that aimed to hedge future increases in energy costs, fuel and agriculture products, which in turn allowed these companies to reduce their risks.

OTC interest rate derivatives did not cause, amplify, or materially spread the financial crisis. OTC interest rate derivatives, which provide valuable interest rate hedging opportunities to global corporations, investors, and individuals, and enhance global resource allocation efficiency, had abso-
lutenly no material affect whatsoever on the financial crisis.37

- Culprit Number 8 was the Securities and Exchange Commission (SEC) and the failure to supervise the bank holding banks. The SEC was reluctant to supervise the over the counter derivatives market. Free market thinking mean that regulators were relying on financial markets to regulate themselves.

- Culprit Number 9 was the failure in leadership. The argument is that President George Bush was disengaged from explaining the nature of the crisis and relied on Treasury Secretary Paulson and Bernanke at the Federal Reserve to deal with the crisis, but also the awareness that the bail-outs ran against the ideology of the administration and the commitment to markets. The initial reaction by the Treasury was passive, allowing the Federal Reserve to take the lead in dealing with the crisis. No one explained to the people the role of the TARP and the decision to spend US$700 billion in the rescue of the financial market.

- Culprit Number 10 was the question of who allowed Lehman to fail. In the case of the attempted rescue of Bear Stearns, the government provided guarantees to ensure the takeover of Bear Stearns by JP Morgan. By contrast, the government made the decision to allow Lehman to fail, which raise the question as to whether this was a problem of ideology with the government bail-out of Bear Stearns being a mark in the sand for no further bail-outs. These decisions created a context of uncertainty. The immediate fallout was the crisis at AIG and then when the Reserve Fund Mutual Fund broke the buck, resulting in the drying of the commercial paper market which put into danger the wider context of the American economy.

**Contestable Terrain Three: ideas and ideals**

Bootle, in his study of the financial crisis, pointed out that the major explanatory factor was at the level of ideas and ideology and the influence of those who gave support to the theory of efficient market in the formulation of policy:

It was the efficient markets theory that really led people up the garden path. This theory holds that whatever information is available about the prospects for an asset that this is embodied in the current market price. . . . The textbook version of capitalism free and uncont-rolled has all along been a fairy tale. But finance capitalism has enacted the fairy tale in real life with witches, hobsoblins and wicked stepfathers along with the fairy godmother.38

He went on to argue that the theory of efficient markets has become a form of a religious fundamentalism that was not open to question, even when the reality of economic conditions were undermining the assumptions of efficient markets:

It is striking how difficult it is to keep a bad idea down. Not only are there still adherents to the ‘crowding out’ view, even in depression conditions, that another version of the idea has sprung up. It is as though what the Keynesians are fighting is one of those creatures of Greek mythology that, as soon as you cut off its head, sprouts another one.39

Likewise, Kaletsky has also tended to put the focus on ideology and the role of efficient market and rational expectations arguments and the influence these ideas had on policy makers:

The quixotic demands to choose between fully predetermined individual micro foundations and uniform rational expectations should have been laughed out of court. . . . Not only did these methodologies seem to turn economics into a mathematically based science, but they had the further flattering feature of allowing the model building econom-ists to decree the universal laws of motion by obeyed by all humanity. Rational expectations did not just raise economics to the same
status as physics they elevated economists to the role that Newton had reserved for God.40

Rational expectations and efficient markets became the dominant ideas that influenced the context and landscapes of policy making after the 1980 heralded by the presidency of Reagan and his commitment markets. The climate of continuing financial stability brought about by Roosevelt regulatory framework provided the opportunity and the context to break free from these regulatory frameworks as memories of the Great Depression were also fading into the distance of time. Fox sees the ascendance of the rational expectations and efficient market theorists as a paradox in the sense that the theories flourished in a climate of stability—a stability that had been brought about by a regulatory framework developed in the aftermath of the Great Depression of 1929:

The efficient market hypothesis, the capital asset pricing model, the Black-Scholes option-pricing model, and all the other major elements of modern rationalist finance arose toward the end of a long era of market stability characterised by tight government regulation and the long memories of those who had survive the Depression. These theories’ heavy reliance on calmly rational markets was to some extent the artefact of a regulated, relatively conservative financial era—and it paved the way for deregulation and wild exuberance.41

Leaders in financial markets gave support to the arguments of free de-regulated markets, of allowing the industry to produce its own rules of behaviour. Arguments for a Ricardian equivalence, financial and resource crowding meant that the role of government was limited. Rational market advocates point to the random walks in financial markets that reflect the balance of investment and savings. Markets therefore allocate investment decisions efficiently and thus confirm intrinsic value.

The contribution of these ideas to the financial meltdown is that they provided the conventional wisdom and the science for de-regulation. Those who therefore argue that that derivatives and credit default swaps were central to financial meltdown are also arguing that it was this rationale that contributed to the climate of deregulation.

The Keynesian Collectivists

By contrast, those who come from a Keynesian tradition tend to argue that the problem is of demand deficiency and falling consumption with the loss of household wealth, which only leaves the government as the most viable consumer.42 In the context of recession, therefore, the government should utilise the excess of savings to invest in infrastructure projects.

The government, Keynes argued, is the only agency that can prevent total spending in the economy from falling below a full or acceptable employment level. If private spending is depressed, it can restore total spending to a reasonable level by adding to its own spending or reducing taxes. In doing so it will be adding to a deficit that is already the result of falling tax revenues and rising benefits due to the recession. The deficit, though, has the function of sustaining the level of total spending and output in the economy. Any attempt to reduce it before a strong momentum to private sector recovery is established will make matters worse. Once the economy has started to grow, the deficit incurred during the recession will automatically shrink to a pre-recession level. Deliberate steps to eliminate the ‘structural’ (i.e., non-recession induced) deficit should be postponed until the recovery is firmly entrenched. With the budget balanced, or even in surplus, at high employment, continued growth will steadily reduce the national debt as a percentage of gross domestic product. This is what happened after the Second World War.43

This category of explanations also includes those who argued that unfettered markets and de-regulation resulted in market failure. Markets failed because of externality problems of their being a
divergence between individual interest and the public interest. Individual interests included the interests of brokers, lawyers, investment bank managers who collected fees in the securisation process. The shift from an originate-and-hold model of banking to originate-and-distribute one created a climate of disavowal of responsibility with individual self-interest eventually harming the wider public interest.

Within this category are also those explanations that connect the financial meltdown to the thesis of the savings glut in the emerging economies and China. Savings outstripped investment demand, which in turn meant a surfeit of savings searching for higher yield. The process of securisation with mortgage-backed securities, CDOs and synthetic CDOs emerged because of an existing demand for these products. Also included in this category is the argument that those authors who argue against rational individualism and point to evidence of herd- ing the idea of uncertainty rather than measuring of risk should revisit the Minsky moment.

The Structuralists

Finally, there are explanations which seek to locate the crisis in issues related to the wider structure of society, including the growth of income inequality and how governments sought to resolve the problem of inequality through low interest rates increased leverage and debt, which contributed to increases in house prices allowing households to take out equity on their homes as a means of improving their well-being. In this way governments did not have to confront the more difficult issue of designing policies that aimed to improve take home pay or to re-distribute income through taxation and improved social provision. In addition to income inequality concerns, the concentration of wealth and power as income is biased towards the top 0.01 per cent of earners, which provides a landscape for the influence of narrow interests groups in shaping the policy process. The study of wages and income equality can be situated into two distinct periods: the years 1950–1974, which Krugman calls the ‘Great Compression’; and the years 1980–present, which he categories as the ‘Great Divergence’. The former is associated with continuing increases in wages and full employment. During the period 1945–1973, productivity and family incomes both doubled. Median income in 1947 amounted to some US$21,700, which by 1973 had increased to US$44,380—an increase of 2.8 per cent per annum—while productivity increased to 103.7 per cent, incomes had also increased to 103.9 per cent. In contrast, during the Great Divergence, which started in 1973, output has increased 3.5 times as much as family income. During the ensuing 27 years, median income increased by 25 per cent, which was about 1 per cent per annum except for a brief interlude between 1995 and 2000 when median incomes were increasing at 2.2 per cent. However, after 2000, median income actually declined by 0.7 per cent per annum. From 1973 to 2000 wages increased from US$44,380 to US$54,000—an increase of 0.7 per cent per annum—while productivity increased by 102 per cent, incomes increased by 20 per cent. So for the period, for 90 per cent of the population incomes increased by 12.5 per cent while the top 10 per cent experienced 40 per cent and the top 1 per cent 75 per cent. However, the study of the top 1 per cent needs to be broken down further with the top 0.1 per cent experiencing an increase of 117 per cent and the top 0.01 per cent, 156 per cent.

In addition, income tax policy changes also contributed to income inequality. Before Ronald Reagan’s election in 1980, the top income tax bracket stood at or above 70 per cent, where it had been since the Great Depression. Reagan dropped
the top bracket from 70 per cent to 50 per cent, and eventually pushed it all the way down to 28 per cent. Since then, it has hovered between 30 and 40 per cent. If President Obama lets George W. Bush’s 2001 tax cut expire for families earning more than US$250,000, the top bracket will increase from 35 per cent to just under 40 per cent—still well below the tax levels of the 1950s and the 1970s.

The tax composition reveals some more shifts. At the federal level, progressive taxes made up 60.8 per cent of the total tax in 2000. By 2005 this had declined to 56.4. Meanwhile, regressive taxes increased from 38.9 to 43.1 per cent. Corporation taxes under Roosevelt amounted to 5.6 per cent of GDP. During the Truman and Eisenhower administrations this had declined to 4.5 per cent, while under Nixon and Ford the tax declined further to 2.7 per cent, then 2.4 per cent under Clinton. In 2007 it dropped to 1.3 per cent, which is the lowest level of corporate tax since 1940.

Rajan has outlined a series of arguments that go beyond economic explanations and instead puts the focus on social issues he describes as ‘fault lines’. Included in his list are the increase in the concentration of wealth and the growth in income inequality as well as the decline in the number of students attaining degree qualifications in the United States, which together have contributed to America becoming less globally competitive and to economic slowdown. Rajan has pointed to the problem of stagnant wages for the majority of Americans, the weak safety net to deal with long-term unemployment, and political paralysis. These factors, he argues, explain why the government used housing policy and easy credit as a form of panacea since this was a policy of least resistance compared to alternative attempts to increase taxes and re-distribute income through public expenditure on health, education and social security.

Politicians have looked for other ways to improve the lives of their voters. Since the early 1980s the most seductive answer has been easier credit. In some ways it is the path of least resistance. Government-supported credit does not arouse as many concerns from the Right at the outset as outright income redistribution would. . . . Politicians love to have banks expand housing credit, for credit achieves many goals at the same time. It pushes up house prices, making households feel wealthier and allows them to finance more consumption.

Geisst has also taken up the connect between stagnant wages and rising house prices. Credit card debt and taking out equity on homes as housing prices were on the rise, providing the avenue to higher consumption even if this was not warranted when wages and household income are taken into consideration.

The increase in house prices and the heightened use of credit cards were accompanied by low growth in real wages as had been the case for two decades. To achieve the American Dream average American families were going into more debt give the low growth in incomes.

Easy credit, the expansion of credit cards and easier mortgages created the possibility for higher levels of consumption that benefitted household and the economy. It was a strategy that at least in the short term only seemed to create winners. The equity and housing bubble confirmed that the strategy of consuming wealth while increasing household debt was, in the long run, not sustainable. The drawing out of equity was directed to consumption without increasing investment.

The question whether politicians used easy credit and housing policy as a palliative to deal with the problem of rising income inequalities without having to deal directly with issues of taxation and redistribution of income is difficult to ascertain since political actors can always deny such intent. After all politicians can point out that in a democracy they reflect the wishes of their voters and
affordable housing seemed to resonate with the wishes of their electors. Wages for 90 per cent of workers in the USA have been rising at a slow pace since the middle of the 1970s. While productivity and the economy have continued to grow the distribution of the proceeds of the economy has been directed toward the top 10 per cent of earners and become more highly skewed when studying the incomes of the top one per cent.50

In their study, Winner take All, Hacker and Pierson point out:

From 1979 until the eve of the Great Recession, the top one per cent received 36 per cent of all gains in household incomes. Economic growth was even more skewed between 2001 and 2006 during which the share of income gains going to the top one per cent was over 53 per cent. . . . More than 50 cents of every dollar in additional income pocketed by Americans over this half decade accrued to the richest 1 in 1000 households.51

Conclusions

The concern of this chapter has been to provide some framework for the reviewing the continuing expanding literature that seeks to explain the nature of the financial crisis. The reading of the literature confirms that these commentaries are contestable, reflecting serious and fierce debates as there were in the 1930 as to causes and remedies to the recession. The stakes are also high since these narratives also seek to shape, define and influence the policy process.

In the immediate aftermath of the financial crisis and even as events were still unfolding between June 2007 and September 2008 there was for a short while an emerging consensus that the commitment to de-regulated markets that started in the early 1980s had come to an end. The financial meltdown confirmed that markets needed to be regulated. Pragmatists and Insitutionalists agreed that there was need for reform which included the regulation of OTCs and CDS markets, putting them into central clearing and trading platforms, and making these de-regulated markets open to price discovery to reduce counter party risk as well as more transparent. There was also consensus on the need for reform in the banking sector—especially on leverage, capital requirements and liquidity. The Frank Dodd Bill of July 2010 reflects that emerging consensus.

Market Fundamentalists have sought to challenge that reformist agenda, arguing instead that it was intervention by government that prolonged the recession. Market Fundamentalists criticised the bank bail-outs as creating a major problem of moral hazard. Furthermore, they argued that the securisation process had contributed to economic prosperity because of the process of spreading risk, which in turn reduced the cost of borrowing. The American mid-term elections in November 2010 seems to confirm a major shift in sentiment since the newly elected Republican lawmakers have strongly argued the case for less government and their primary aim is to reform the Fran Dodd regulatory reforms.

The Keynesian Collectivists and Structuralists arguments are attempts to connect the recession with household income inequality and the concentration of wealth. The slow growth in income during the past twenty years confirms a shift from the twenty years after the Second World War when both median income and wand productivity were both rising. While GDP has continued to increase since the 1980s, most of the fruits of the new income have been concentrated towards the top 1 per cent of earners. The policy of low interest rates and easy credit has provided the avenue for median income households to increase their consumption and living standards, which has come at the cost of higher household debt. The United Kingdom government is committed to reducing public expenditure by £80 billion during the next five years, while in the United States there are recent Commission recommendations to
increase the pensionable age to 70, reduce Medicare and other social provision policies. In both the United States and United Kingdom, these measures would result in increased inequality. However, other countries, including Greece and Ireland, have had to reform welfare provision in order to deal with mounting public sector deficits as they try to stabilise their financial markets.

Notes

4 Ferguson, ‘today’s modern Keynesians’.
7 Summers, ‘America’s sensible stance on recovery’.
8 Wolf, ‘Why the battle is joined over tightening’.
13 E. Dinallo, Testimony before the Financial Crisis Inquiry Commission Hearing on the Role of Derivatives in the Financial Crisis, Thursday, 1 July 2010; G. Gensler, Statement of the Chairman, Commodity Futures Trading Commission before the Financial Crisis Inquiry Commission, 1 July 2010; J. Masters, Testimony to the Financial Crisis Inquiry Commission Hearing on the Role of Derivatives in the Financial Crisis, Thursday, 1 July 2010.
14 Gensler, Statement, p. 9.
20 Kohlhagen, Testimony; Kyle, Testimony.
21 Schwarze, Testimony.
24 R. S. Fuld, Written Statement before the Financial Crisis Inquiry Commission, 1 September 2010; J. Cayne, Testimony.
before the Financial Crisis Inquiry Commission, 5 May 2010.


29 Reinhart and Rogoff, ‘Is the 2007 US sub-prime financial crisis so different?’.

30 Dinallo, Testimony, p. 10.


33 B. Bernanke, Statement by the Chairman, Board of Governors of the Federal Reserve System before the Financial Crisis Inquiry Commission, 2 September 2010.

34 Bernanke, Statement, p. 3.

35 Bernanke, Statement, p. 17.


37 Kohlhagen, Testimony, p. 1.


42 P. Krugman, ‘Why did economists get it so wrong?’, New York Times, 6 September 2009; Stiglitz, Free Fall; Skidelsky, ‘Future generations will curse us’.

43 Skidelsky, ‘Future generations will curse us’.


46 Krugman, ‘Why did economists get it so wrong?’.

47 Rajan, Fault Lines.

48 Rajan, Fault Lines, p. 31.

49 Geisst, Collateral Damage, p. 166.

50 T. Piketty and E. Saez, in Stiglitz, Free Fall.

51 Hacker and Pierson, Winner Takes All Politics, p. 3.