How to Get Out of a Financial Crisis?
Financial Institutions, Government and the Role of Civil Society

Vincent Bignon
Summary

• Nature of a financial crisis
• Current consensus on the cure for financial crisis
• Problems with this consensus
  – Timing
  – Criteria for a good policy
  – Anti-poor policy
• What alternative policy?
• Role of civil society
What is a financial crisis?

• This is the moment at which losses of financial institutions are realised or learned.
• Those losses can be increased/amplified because of the crisis if it involves further decrease of the price of financial assets.
• Before that moment, the losses could have existed but they were potential.

⇒ Key question: who will pay for the losses?
Implications

• What arguments will be used to legitimate the use of taxpayers money to bail out the financial sector

• Timing issues:
  – It is already too late, at the moment at which the crisis had burst, to avoid the losses
  – The losses grew during the crisis as exemplified by the 2007 episode
Calendar of events

• 2005-2006: increase in foreclosures, delinquency rate on mortgages increased
FORECLOSURE FILINGS, NUMBER OF HOMES IN FORECLOSURE AND HOMES REPOSSSESSED

2005  2006  2007  2008  2009  2010

(projected)

4 million
3.5 million
3 million
2.5 million
2 million
1.5 million
1 million
500,000
0

NUMBER OF FORECLOSURE FILINGS

May 10, 2010: 23.3% of U.S. mortgages "underwater."

November, 2009: "More than 40% of borrowers who took out loans in 2006 -- when home prices peaked -- are underwater." --WSJ

May 23, 2010: "Home foreclosures probably will reach a record this year with more than 1 million properties seized by banks." --Bloomberg News

NUMBER OF HOMES FILED UPON

Homes lost a total of $1.4 trillion in value in the fourth quarter of 2008 alone -- more than the $1.3 trillion in losses in the entire year of 2007 -- for a total loss of $3.3 trillion in 2008.

NUMBER OF HOME REPOSSSESSIONS
Calendar of events

• 2005-2006: increase in foreclosures, delinquency rate on mortgages increased
• Winter 2006-7: Investment banks begun to realize that they lent to much and too badly
• Summer 2007: First losses accounted by vehicles of financial intermediaries (BNP Paribas, Bear Stern)
• And the rally begin
Calendar (cont’d.)

• Interbank interest rate skyrocketed, reflecting
  – Doubts about the solvency of competing banks
  – a predation game among banks: weakening the weakest further (to buy cheaply)

• March 2008: Bear Stern bought by Merryl Lynch

• September 2008: Lehman bros went bankrupt

• Medias started investigating what is happening
Current consensus among policy-makers

• Solving a financial crisis implies
  – Massive transfert to the financial intermediaries
  – Restructuring of the financial sector
  – Offensive interest rate policy

• Justification: Too big to fail.

• Bi-partisan solution (no resurgence of Pdt Roosevelt anti-financial stance)
Contemporary Monetary Policy Stance During Crisis

• The standard tools used in any crises since the beginning of the 1990s
  – Huge and speedy decrease of the central bank’s interest rate & increase of the volume lent to banks
  – Benefit to the financial institutions that borrowed at the central bank
  – Increased the interest margin of lenders (increase of future profit)
Fed Funds Rate & Mortgage Rates 2001 - 2008

Source Data: U.S. Federal Reserve, Freddie Mac
Since the beginning of the financial market turmoil in August 2007, the Federal Reserve’s balance sheet has grown in size and has changed in composition. Total assets of the Federal Reserve have increased significantly from $869 billion on August 8, 2007, to well over $2 trillion.
Novelty of current cure

• Quantitative Easing: central banks lent against troubled assets
• Central banks lent against bad collateral, i.e. assets that no one knows whether they will be repaid
  – The FED’s holding of MBS and other complex derivatives products
  – The ECB’s buying of governmental bonds
• Is a monetary equivalent to the TARP
• Is a novelty of this crisis (contrast w/ 19th c. practices of lender of last resort)
Central banks balance sheets
Beneficial Consequences for Financial Intermediaries

• The flow of future revenue is increased because the interest margin widened
• Their balance sheets were discharged of the assets that were the most risky (the potential future losses are reduced).

⇒ the central banks transferred money/subsidies to the financial intermediaries
⇒ was this as necessary as it was advocated?
What Motivated These Transfers?

• It was advocated that they will help to avoid negative externalities such as
  a) The collapse of interbank lending market
  b) The collapse of the banking system and of the payment system (heard esp. in 2008)
  c) Incentivizing the banks to continue to lend to the private sector
• Prove sufficient to avoid b) but not a) and c)
• Interbank market is still not very active today and interest rate are above the central bank rate
• The level of lending did not have yet resume to pre 2007 level
What about the reaction of the States?

- Increased fiscal deficit and
- Provided temporary budget subsidies to the demanding banks through special lending or subscription of quasi-equities
- Organized mergers of weakened banks with healthier ones (with stop-loss rule)

⇒ Reduced competition in the banking industry and must have implied higher cost of financial services for customers
To sum up

• Huge transfers of funds to the financial sector (act as a public subsidy to the banks).

• For what rationale?
  – Avoiding greater losses through a deeper recession?

• But in the same time other bubbles were fueled, destabilizing other financial markets
  – oil market, commodities, government bonds
To sum up (2)

- Of course, this helps to maintain the level of profit of financial intermediaries
- But at what price?
- Could things have been done differently?
Criteria of a good crisis policy

• Define a policy that provide ex ante the incentives for financial intermediaries to solve the temporal consistency problem associated with lending
• Any policy that allow banks to be discharged of this liability does not fulfill this criteria
⇒ Main problem w/ current policy
• Alternative: Provide public aid at a very high price
Other Possible Policy Stances

- History provides a nice example of another possible policy to cure financial crisis
- The doctrine of the Lender of Last Resort (Bagehot, 1873)
  - Lend freely
  - At a punitive interest rate
  - Against good collateral
- Rationale: derived from what drives banks’ action during a crash (interbank market)
The vanishing impact of financial crisis in France (1820-1913)

Deviation of the cyclical component of the bankruptcy rate to its trends (HP=6.5)
Features of the alternative

• Greater supervision of the banking sector
• Makes the banks pay a higher price for the needed liquidity
• Provide incentive for the financial intermediaries to produce information on both the borrowers and potential losses
Obstacles to the implementation of such policy?

• The capture of the politics by the banking and financial sectors
  – The French program to help banks was said to have been advised to the French president by the CEO of BNP-Paribas, the biggest French commercial bank
  – The former economic adviser of Pdt Sarkozy ended up CEO of a merged commercial bank during the course of the crisis, after having had supervised its restructuring
And in the US?

• Most treasury secretaries holds positions in Goldman Sachs (e.g. Rubin, Paulson…), the most influential Wall Street investment bank
• Policy action were taken to avoid supervision of the derivatives industry as early as 1998 (Washington Post)
• Wall Street is the biggest contributor of campaign funds and lobbies intensively
  – Article by Tressel et al, 2009, IMF working paper: A Fistful of Dollars: Lobbying and the Financial Crisis
  – Book of Johnson and Kwak (13 bankers)
The role of citizens and civil society

- Learn and publicize the intimate link between banks and governments,
- Argument for public aid: Improve the economy or subsidizing the banks?
- Other policies were implemented successfully in the past but they can come with a price
- But no justification that this cost is greater than the one we are actually paying
Conclusion

• Who deserve bail out?
  – Banks or homeowners?
• Price paid by banks of a bail out should increase hugely
• Timely action is necessary. May imply anti-trust policy at any stage of the crisis
• Whither white collar crime?