The Economist

Will next time be different? A report from the 30th Cato monetary conference

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EVERY year, the Cato Institute hosts a conference on monetary policy, inviting distinguished academics, policymakers, and journalists to present their views on a wide range of questions. On Thursday, your correspondent attended the 30th annual conference. What follows are my impressions of the first portion of the event, which was about the origins of the crisis and ways to prevent future ones.

The keynote speech was given by Vernon Smith, who shared a Nobel with Daniel Kahneman for his work on behavioural and experimental economics back in 2002. Mr Smith argued that America's Great Recession (or, as some prefer, Lesser Depression) was qualitatively similar to the Great Depression but qualitatively different from all the other downturns the country experienced since the beginning of the 20th century. For Mr Smith, the distinction is that the Great Depression and the Great Recession were preceded by mortgage credit bubbles that subsequently collapsed. The decline in asset values was exacerbated by the large overhang of debt, which dragged down the economy and stifled the recovery. As long as households and businesses continue to repair their balance sheets, there is little prospect for a robust recovery—a theme that should be familiar to regular readers.

Mr Smith's talk was full of interesting historical information. For example, mortgage underwriting standards (such as maximum LTV ratios, amortisation rules, etc.) were very loose in the 1920s but tightened considerably by the mid-1930s. By the 2000s, however, standards had reverted:

> Commercial banks in the 1920s made predominantly interest only and partially amortized mortgage loans of 3-4 years term, then rolled them over by refinancing, or otherwise a balloon payment was due. Then in the 1930s strong traditions emerged supporting amortization of mortgage loans; by 1934-1939 69% of commercial bank mortgage loans were amortized. In addition, traditions supported 30% down payments, and due diligence in mortgage originations. But by the 1990s these traditions had badly eroded; in 2005, 45 percent of first time

> home buyers (National Association of Realtors data) made zero down payments—100% OPM.Similarly, we had the spectacle of upfront fees (OPM again) for mortgage origination. The latter is a prime example of a bad property right rule with a simple fix: whatever is the fee for origination, the rule would be that it has to be spread over time in proportion to the borrower's payment of principal. If the loan is interest only for ten years, then there is no fee payment for ten years; on amortized loans the fee would be escrowed into monthly payments along with principal reduction. This would give the originator the same proportional risk exposure, and the same due diligence incentive, as a lender; the market would then determine the fee level and whether or not lending and origination is best combined or separated under this incentive compatible rule structure.

Mr Smith also had a helpful explanation for why the decline in equity prices in 2000-2002 was much less damaging than the decline in house prices since 2006, even though the dollar value of the losses was about 4 times larger when share prices tumbled. The reason was that stocks were largely owned outright, rather than borrowed with other people's money. Moreover, banks generally did not own many stocks. This is noteworthy given the Federal Reserve's discussions on the impact of a housing bust, such as at this meeting in mid-2005. John Williams, an economist at the San Francisco Fed, made much of the fact that the collapse of the equity bubble led to a mild recession (see his presentation on page 26 of this PDF). According to him, a 20% drop in house prices from the mid-2005 level would destroy far less household wealth. As a result, he was confident that the Fed could easily prevent the unemployment rate from rising above 6%. But leverage magnified the relatively small decline in asset values into a much larger shock to net worth.

Mr Smith persuasively argued that a robust recovery will not occur until the private sector's unpayable debt burden is liquidated. Could the government speed up this process? Richard Koo, the chief economist at the Nomura Research Institute, has argued that an increase in government indebtedness can help the private sector repair its balance sheet more quickly. According to Mr Koo, government deficits provide extra income to those trying to repay their debts and additional assets to those accumulating more savings. Mr Smith, however, dismissed the notion that public deficits can help in our current situation. In fact, he argued that fiscal stimulus would have no effect until after the private sector had finished restructuring its liabilities.

One of my colleagues moderated a panel discussion on how to prevent the next crisis after Mr Smith's thought-provoking speech. The first speaker was Tom Hoenig, who was in charge of the Kansas City Federal Reserve for two decades before joining the board of the Federal Deposit Insurance Corporation (FDIC). Incidentally, Mr Hoenig was one of the first people at the Fed who warned that the sharp interest-rate cuts in 2001 might inflate a housing bubble. He argued, like the Bank of England's Andy Haldane at this year's Jackson Hole conference, that the Basel regulations on bank capital and liquidity are too complicated and ought to be replaced by simple rules. In particular, he thought that "risk-weighting" should be scrapped in favour of a single ratio (around 15%, which was the norm in the United States prior to the creation of the Federal Reserve as a lender of last resort) of tangible common equity to assets.

The standard argument against a simple leverage ratio is that it encourages banks to load up on the riskiest possible assets, which, over short periods, would maximise the return on equity. Mr Hoenig thought this could be prevented by supplementing the minimum

capital requirement on the basis of supervisory inspections into underwriting standards. Rather than determining risk by the type of asset (mortgage, commercial loan, etc.), regulators should concentrate on more basic questions like documentation and loan-to-value ratios. The FDIC already assesses different deposit premiums on banks depending on their safety and soundness rating. Mr Hoenig believed that these strict rules would encourage the return of narrow banking and improve the resilience of the financial system.

Harvard's Jeffrey Miron went next. He argued that there was actually no point in trying to prevent financial crises. First, crises seem to have no lasting impact. Indeed, he showed that American industrial production has grown remarkably steadily since 1790, with the exception of the Great Depression and WWII. While this supports Mr Miron's claim that financial crises have left no long-lasting scars in the world's most successful country, it could also be read to suggest that devastating wars, pandemics (such as the Spanish Flu), and government policies that Mr Miron might characterise as "repressive" also have no lasting impact. Acknowledging that crises can sometimes lead to painful short-term fluctuations, Mr Miron still advises against crisis prevention measures because the "cure would be worse than the disease." As far as your correspondent could tell, Mr Miron presented no evidence in support of this assertion.

Larry White, an economist at George Mason University who has been attending the Cato conference since its inception, echoed the ideas of Nassim Taleb, (see our review of his latest book here), arguing that we should make our financial system "antifragile." This means that it would actually become stronger when hit with a moderate shock, in the way that muscles get larger after lifting weights. For Mr White, that means taking away the government safety net, including deposit insurance and the Federal Reserve. While intellectually appealing, the problem with Mr White's formulation is that it would require depositors and other creditors to audit the safety and soundness of any bank they consider transacting with. But most people who use the payments system have neither the time nor the capability to do this. Even bank executives have a hard time figuring out an institution's risk exposure! Since a stable payments system is a public good, eliminating all government guarantees might be dangerous. In the United States, the record since 1934 suggests that public insurance schemes have successfully insulated the deposits and transactions of innocent bystanders from crises caused by others. This has come at the cost of additional moral hazard, as Messrs Hoenig and White both mentioned. The question is whether the sorts of common-sense regulations advocated by Mr Hoenig can cancel out the implicit subsidy for risk-taking. If not, Mr White's more radical approach might be best.

The final presenter on the panel was Robert Hetzel, an economist with the Richmond Fed. He began by noting that central bankers spend most of their energy on forecasting the future and reacting to changes in their forecasts. According to Mr Hetzel, this is a fool's errand if central bankers do not know how their actions affect the economy or why particular events occurred. Was the bubble and bust caused by an emotional cycle of fear and greed, or by monetary policy shocks on both the upside and the downside? In his paper, Mr Hetzel made the provocative argument that the Fed, not the financial crisis, was responsible for the downturn in 2008, although he did not discuss the point at the conference. Instead, Mr Hetzel argued that the task ahead is not the development of better predictive indicators, but a thorough assessment of the historical record to determine how the system works. Of course, that would require policymakers to admit when they had erred.

One question after the formal presentations particularly struck me. The questioner asked whether private firms could take on the roles of the FDIC and Federal Reserve, thereby giving everyone the benefits of having a safety net without allowing the government to get involved in the markets. While Mr White spoke approvingly of the bank clearinghouse associations that existed in the 1920s and before, Mr Hoenig made the sensible point that it is impossible to eliminate risk by moving it from one group of private firms (banks) to another (the private insurers). Similarly, Mr Hoenig is sceptical of the gains to be had from moving derivatives transactions from the over-the-counter markets to exchanges. Mr Hoenig did not go on to add, as I did under my breath, that the performance of the monolines during the crisis does not fill one with confidence.

Returning to the title of this post, it is not clear whether next time will be different. No one thought that the post-crisis reforms would do much for financial stability. Virtually everyone agreed that the Federal Reserve had failed to learn the right lessons—an impressive consensus considering that many disagreed about what those lessons are (a subsequent post will have more on the subject). However, the intellectual vitality and diversity of the conference is encouraging. Forums like Cato are fertile ground for ideas excluded from the mainstream. Most such ideas might be unhelpful. But some might make a genuinely positive contribution. All should be listened to.

The rest of the conference will be covered in a subsequent post.