Coping with Today’s Financial Crisis: Lessons from the Past

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September 29, 2008

The title of this talk is “Coping with Today’s Financial Crisis: Lessons from the Past.” However, given everything that is happening, it will focus less on the past and more on the current crisis. It will look specifically at three issues surrounding the current crisis. The first is the origins of this crisis, specifically considering some of its more important implications that indicate what needs to be done. Second is a look at the efforts made to deal with the crisis so far. Although the bailout proposal is getting a great deal of attention now, numerous efforts have already been made and more will certainly follow it. The final and perhaps most important issue is that of post-crisis reform: what needs to be done and what are the prospects for successful reform. There have been a number of reform proposals and arguments about what should be done. However, the issue of what should be done must be considered in conjunction with what can be done, and this really depends on what can be negotiated between the relevant players.

Of course this is a very opportune time to have this talk as a number of important events are taking place today. The U.S. House of Representatives should be voting on the proposed bailout package today (September 29). The Senate will vote on Wednesday (October 1). There are also three bailouts taking place in Europe: the governments of Belgium, the Netherlands and Luxemburg have created a US$16.4 billion bailout package for the banking and insurance giant Fortis; the United Kingdom government has nationalized the US$91 billion mortgage lender Bradford & Bingley; and the German government has announced a bailout of Hypo Real Estate Holding AG. This indicates that the crisis is still far from over. Yesterday the expectation was that news of an agreement on the final text of the bailout finally being reached after long and tense negotiations would calm markets. However, this was not the case as concerns over the crises persist and were confirmed with the three abovementioned bailouts. The final important event taking place today is the meeting of the Financial Stability Forum (FSF). The FSF consists of representative from the major central bank and finance ministers from 26 countries, representatives from a number of international financial institutions such as the International Monetary Fund (IMF) and World Bank, and representatives from a number of international standard setting, regularity and supervisory organizations. Back in October 2007 the G7 finance ministers delegated to this organization the role of central planning body, or think thank, for dealing with the crises. The organization has met regularly since then to discuss what needs to be done in the short term and what long-term reforms are necessary to prevent a repetition of the current crises.

It is important to point out one important caveat about this presentation. When discussing the then ongoing crisis in Asia in Globalizing Capital, Stanford economist Barry Eichengreen quoted Sir Walter Raleigh: “Those who follow too close on heels of history risk getting kicked in the teeth.” There is a similar danger in discussing the ongoing subprime mortgage crisis. However, the majority of the conclusions contained herein are, to borrow a British expression, “as safe as houses.”
Causes of the Crises

It is important to look at the causes of the current crises because they have a direct bearing on what needs to be done to fix the underlying problems. However, first it is first important to ask why this is crisis so important?

The most obvious is its size and scope. Financial crises are actually relevantly common but tend to hopped at a much smaller scale. However, these smaller crises do not get as much publicity or dominate our thinking as do more serious collapses such as the Asian financial crisis or the stock market crash of 1929. But the recent past has had its fair share of crises. Thus, Japan experienced a meltdown of its financial system during the 1990s. The U.S. has experienced a number of financial crises, including the so-called dot.com bubble that came to a head around 2005, the savings and loan crisis of the 1980s and the stock market crash of 1987. But unlike these crises, the problems coming out of the U.S. mortgage market today are beyond the ability of the U.S. to manage on its own. Although recent news headlines have focused on what the Treasury and Congress have been doing, resolving this crisis depends on the coordinated action of the key international financial players and they have been playing their part. This crisis is on a scale not seen in a long time, even when compared to the Asian financial crisis.

Another important factor is the fact that the current crisis originates in the very core of the international financial system. The impact of the Asian financial crisis must not be minimized, but the fact that it did not hit the core of the international financial system is significant. The current crisis is happening at the very core. Such crises are inherently more dangerous and are more likely to affect the international economic and monetary system as a whole than are crises that originate in emerging markets.

Finally, this crisis is important because it is taking place at the same time as other serious economic problems: rising oil prices and other problems in the energy sector, high U.S. deficits and the prospect of not only a recession but a return to stagflation – the simultaneous contraction of the economy and a rise in inflation. Many have compared the current crises to the Great Depression, but in fact it is more like the problems the world faced in the 1970s.

It is also important to consider the crisis in terms of the general debates about financial crises. The first is the debate about whether the responsibility for financial crises falls on markets themselves or on government policy that distorts market incentives. It is not much of an exaggeration to say that on one end of this debate people tend to see markets as infallible except when led astray by irresponsible government policy. On the other hand, they see markets as full of irresponsible speculators who must be reined in by sound government agencies looking after the public good. It is, in the end, ironic that to some the same human beings are seen as being either short-sighted and incompetent or reasonable and effective depending on whether they are found in an office building or a legislature.

The second debate centres on the issue of crises contagion. That is, how far will the crises spread? The current crisis has already spread to other financial markets and the real economy in a number of ways. Today’s financial markets are very interconnected, which means nearly all of the world’s financial centres are vulnerable to the fallout from Wall Street’s financial problems. This vulnerability comes not just indirectly, by panic spreading from one market to another, but rather through securitization that links global financial markets directly to the U.S. mortgage market. These problems can spread further to the real economy beyond that of the U.S. through the increasing reluctance of banks to lend money – the so-called credit crunch – and by a loss of investor and consumer confidence. These economic effects can have ripple effects that can extend to diminished trade and investment the global economy.

So what are the causes of the current crisis in the U.S.? There are five general causes that can be detected: the dot.com bubble, weakened oversight and deregulation, speculation in the housing market, government policy and the securitization of mortgages.
First, in the dot.com bubble of the late 1990s and early 2000s a great deal of capital flooded into the so-called new economy. This led to inflated stock prices of most internet-related business. As is usually the case in these situations, when this bubble burst investors were concerned with finding safe havens for their money. Traditionally housing is one of the safest investments and as this sector was growing at the time much of the dot.com money found its way into the housing market. This increased prices and prompted more investor interest in the housing market.

Second is the formal and informal process of weakening oversight and outright deregulation of financial markets. The role played by deregulation is a contentious and partisan issue, but weakening oversight was in part responsible for the increased risk taking in the housing sector. Weakening oversight does not refer only to a lack of government regulation. In addition to the rollback of government regulation in the U.S., the role played by private oversight institutions in the crisis is significant. Rating agencies, mortgage brokers and self-regulating banks all failed to manage risk and provide due diligence. With regard to the failure of financial oversight, the example of Enron reveals how it was possible to actively mislead investors with the help of private and supposedly independent accounting firms.

Third is the speculation in the housing market. In the U.S. there is a tendency to portray this crisis and the bailout effort as a fight between Wall Street and Main Street, but the situation is much more complicated. Wall Street should not be exonerated: there has been a good deal of greed and reckless behaviour there. However, there was also a great deal of speculation on the part of Main Street as well. Thus, in 2005 around 28% and in 2006 around 22% of housing purchases were investments: people buying homes not to live in them but to “flip” them for profit. This practice was so popular that there are a number of reality television programs – “Flipping Out,” “Property Ladder,” “Flip this House,” etc. – which portrayed people buying and renovating a house so they could sell it for a profit.

Fourth is government policy. The U.S. Federal Reserve interest rate policy made investing in housing look more attractive than it was. However, this does not get investors off the hook since forward looking markets should have been able to avoid this temptation. A more serious issue is the role played by the Community Reinvestment Act of 1977. This act was aimed at getting loans to minority and low-income household that had historically been denied access to leaning due to so-called “redlining” policies. Though the act had been around since the 1970s it was deal law until the Clinton Administration breathed new life into it in 1995. Despite halfhearted attempts to modify this policy under the Bush Administration it was still in force after 2000. This policy lead to the creating of subprime mortgages and strengthened the profits and influence of Freddie Mac and Fannie May two government sponsored entities which backed a large potion of the mortgage market in the U.S. This did contribute to a number of problematic mortgages that would lead to the crisis. However, it should also be pointed out that many bad mortgages were not a direct result of this program and that many mortgages that have come out of this program have not turned bad.

The final cause was the introduction of a number of innovations to the mortgage market, in particular the securitization of mortgages. Although this factor is less important as direct cause of the crisis, it did play a role in distorting perceptions of the risk associated with investing in the mortgage market and thus led to more reckless behaviour. However, its real importance lies in the spread of the effect of the crisis far further than would otherwise have been the case. If the current subprime mortgage crisis is compared with the savings and loans crisis of the 1980s, which are very similar in many respects, one thing that stands out it how far the effects of the current crisis are felt and how quickly those effects spread to the rest of the financial system. The trading of mortgage-backed securities spread the crisis to Wall Street, to banks in Europe and Asia, and even to small towns around the world that had turned to these securities as safe investments.

Thus there are multiple causes to the current crisis. One negative side effect is that it politicizes the discussion about the crisis. Many commentators, on both the left and right, have
interpreted the situation through their own ideological filters in order to support their own agendas. Thus believers in free markets can point to the government’s role and use this as grounds for criticizing any government efforts to fix the problem. Those who are skeptical about financial markets can point to government deregulation and the failure of market self-regulation and call for more government oversight. Some turn to populist rhetoric portraying the crisis as a struggle between Wall Street versus Main Street. There is enough blame to go around. Nonetheless, these debates do tell us that the crisis response and post-crisis reform efforts are going to be very politicized and difficult.

There are a several points to be made about financial crises in general.

First, financial crisis are inevitable. There is no way to build a crisis-proof system because financial markets are constantly changing and evolving. It is therefore impossible to perfectly predict and deal with every possible problem before it develops into a full-blown financial crisis. And since crises have serious economic cost, crisis response will always be an important government responsibility.

Second, national financial systems are and will likely continue to be increasingly interdependent. Thus, crisis response is increasingly going to have to take the form of international cooperation. Even in the current crises, even though most of the media attention in North America has been focused on the U.S. government, there have been a series of international efforts that are just as important for stabilizing distressed markets. This international cooperation is significant because it will be essential for any post-crisis reform efforts.

The final point is about the relationship between financial crises and reform. Meaningful reform requires political will and an intellectual consensus on what needs to be done. Unfortunately these essential preconditions for reform are often lacking. Dramatic events, such as serious financial crisis, are able to produce a consensus – though admittedly not always the correct one – that certain action is required and that it is required sooner rather then later. This situation is illustrated by the cases of the Mexican peso crisis of 1994/95 and the subsequent Asian financial crisis of 1997/98. After the so-called “Tequila crisis,” Canada made reform of the international financial architecture a key issue when it hosted the 1995 Halifax G8 Summit. However, given the limited effects on the G7 of this crisis – which primarily affected the U.S. and Canada – little progress was actually made until after the outbreak of Asian financial crisis two years later. It was the Asian financial crisis that signalled to all that something had to be done.

**Crisis Response**

First, it is important to explain the logic and dynamics of crisis response. Financial crisis response consists of two elements: immediate responses and post-crisis reforms. The latter, however, is only necessary if a crisis is due to more serious underlying problems and not just market illiquidity. These two tools are in most ways analogous to the roles played by paramedics and doctors. A paramedic is there to deal with the immediate problems – to stop the bleeding and get the patient to the hospital. It is then the doctor’s job to deal with the more serious underlying problems – stitch up the wound and deal with any complications. Similarly, the goal of crisis response is to injecting liquidity into distressed markets and to make policy commitments that will reassure investors that underlying problems will be fixed. This is what current efforts are focused on. The prospects for post-crisis reform are below.

The effectiveness of any crisis response effort does not depend merely on the government stepping in with the right policy measures. Just as important, if not more so, is the government’s ability to convince markets on the one hand and political constituencies on the other that the steps being taken are necessary and that the government will live up to its promises. If the bailout package does not convince investors that the government is going to make necessary reforms that will fix problems in underlying fundamentals, then it simply will not work. Financial markets are
so large today that they easily dwarf a government’s resources. A bailout without policy commitments under current conditions merely provides temporary price supports and in the long run is little more than throwing money away. Injecting liquidity is an important aspect of restoring confidence, but on its own it is not very effective.

The politics dimensions of crisis response are equally important. Larger bailout efforts often need the support of the legislature. But even when they do not, financial crises and bailout efforts, especially those that are unsuccessful, can have negative political consequences. Already in the U.S. resentment toward the government’s plan to deal with the crisis is growing. As mentioned, the crisis and the bailout plan have generated inappropriate accusations of Wall Street versus Main Street. Many have characterized the current plan as an effort to use taxpayer money to rescue the greedy financial institutions while leaving ordinary Americans in the lurch. This is, of course, a gross oversimplification but it perfectly illustrates the political backlash that bailout efforts can generate. It also illustrates the importance of making sure that a bailout has some level of public support. Thus, in essence, crisis response is an attempt to deal with financial problems while balancing the often conflicting concerns of financial markets and voters.

Prior to the current US$700 billion bailout plan there were numerous international efforts to deal with the crisis.

First, there has been a series of coordinated open market operations to inject liquidity as well as active use of interest rate policy. Both these interventions aim at dealing with the credit crunch produced by the crisis. The first of these took place in August 2007 when the U.S. Federal Reserve, the European Central Bank and the central banks of Canada, Japan and Switzerland intervened to inject liquidity in the market. By September 2007 the Bank of England joined these efforts. Similar coordinated efforts were made in December 2007, in March/April 2008 and on September 18.

Second, there have also been a series of direct government bailouts to help distressed banks. On February 17, 2008, the Bank of England nationalized Northern Rock Bank. In September the U.S. government bailed out Fannie Mae and Freddie Mac and later AIG. At the same time the U.S. Treasury has supported a number of private sector bailouts and takeovers. In fact, it is a something of a surprise that the Federal Reserve did not bailout Lehman Brothers and this was probably a serious mistake on its part. The US$700 billion bailout package proposal by the Treasury secretary and Federal Reserve chair is really just an attempt by the U.S. government to get away from ad hoc bailouts to a more systemic approach.

Third, there have also been more general attempts to stimulate economy and thus avoid or minimize the coming recession, which, truth be told, is already here. The most prominent of these was the Economic Stimulus Act of 2008 passed by the Bush administration. However, the timing of this stimulus package was very unfortunate. The tax refund came in late April and May, and was quickly neutralized by the major increases in oil and food prices over the summer. This effort was not irrelevant but it did not boost the economy as was hoped.

Finally, in addition to these short-term efforts, there have also been efforts of a more long-term and multilateral focus. Last October, the G7 commissioned the FSF to create a plan for dealing with crises. The FSF submitted a proposal on April 12 that emphasized strengthening prudential oversight, enhancing transparency, changing the role and use of credit ratings, strengthening responsiveness to risks and producing robust arrangements for dealing with stresses in the financial system (see “Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience” available from the FSF website). So far the G7 has approved of these suggestions and they are likely to be the basis of the G7’s post-crisis reform efforts. Today [September 29], the FSF is meeting in Amsterdam. In terms of long-term recovery, this may be more important than the vote in Congress, although the bailout is still critically important in the immediate term. Of course, the G7 finance ministers have not just delegated their responsibility to the FSF but have been meeting regularly to discuss the crisis. The Italians, who are taking over
the presidency of the G8 in 2009, have recently announced that they will make fixing the problem in international financial system a priority at the next leaders summit.

With regard to the US$700 billion bailout package, the first question is whether it is really necessary. The plan has received a great deal of opposition from many sections of the American polity. However, probably the most meaningful is the recent open letter signed by more than a hundred academic economists criticizing the original plan on three main points: fairness, ambiguity and long-term effects. (The letter and the list of signatories are available here.)

In terms of fairness, those economists say that it amounts to a subsidy to investors at the expense of taxpayers. However, this is not a criticism of the need for government intervention in general. Rather, it is a criticism of the massive scale and focus of the current plan. As they point out, not all failures carry a systematic risk, so that “the government can ensure a well-functioning financial industry … without bailing out particular investors and institutions whose choices proved unwise.” Thus some institutions should be allowed to fail, but this does not mean that the government can ignore the consequences of all collapses.

In terms of ambiguity this group of economists is concerned that “neither the mission of the new agency nor its oversight are clear.” This is an important point that has concerned many. Giving so much discretionary power in times of crisis should raise concern.

Finally, in terms of the package’s long-term effects, the economists say: “For all their recent troubles, America’s dynamic and innovative private capital markets have brought the nation unparalleled prosperity. Fundamentally weakening those markets in order to calm short-run disruptions is desperately short-sighted.” This is a good point, but it is not clear that weakening of financial markets will be a necessary result of the bailout package.

All of these points are valid. They do not amount to saying that some form of bailout is not necessary. As the letter itself states, these economists are calling for more caution. They are not saying that no bailout is needed. They are, in fact, saying these concerns must be addressed before a bailout agreement is made. And last week and over the weekend a number of modifications to the original three-page proposal were made. The bill is now more than a hundred pages long. Have the modifications addressed relevant concerns?

Before this question can be answered, there is more to say about the more extreme opposition to the bailout plan. Although this criticism is not very serious, it does provide an interesting insight into some of the challenges the plan will face. A number of arguments were made on the floor of House on September 29 about how “un-American” this plan is and how it is a slippery slope to socialism. This kind of criticism should not surprise anyone. There are always groups ready to rail against the dangers of socialism. During the Cold War, there was a great deal of controversy over the introduction of the polio vaccine and the fluoridation of water, both of which were seen by some as attempts to weaken the will of Americans to resist a socialist takeover. Perhaps the most ridiculous of these accusations was the opposition to Alaska’s Mental Health Enabling Act of 1953, which to some was a thinly veiled attempt to transform Alaska into Siberia and masquerade gulags as mental hospitals. There are legitimate concerns about what will happen to the mortgages bought by the government and to any controlling stakes it acquires in the financial sector – such as the one it now has in AIG. However, the governments of both the United States and the United Kingdom have made it clear that they have no interest in permanent nationalization and that they will eventually privatize any firms they acquire. And if they decide not to, such a decision will undoubtedly generate controversy. It will be within the power of voters and elected representative to change it.

It is also informative to look at the market’s reaction to this news. On CNN and other news sources yesterday, there were high hopes that the proposed bill would give a great boost to market confidence. Markets were expected to rally, starting in Asia, moving on to Europe and then, finally, the boost in the New York Stock Exchange would be the icing on cake. This did not happen. In part, this was because of the news of the bailouts in Europe. These were major financial institutions and it was a clear signal that things are still not completely under control.
Another reason for the lack of a boost is that Wall Street and other markets are worried about some measures that have been added to the plan. It has been modified to great extent in order to make it politically palatable, but these provisions are not what the market wanted. This brings the discussion back to the tension between investors and voters, which is very important in determining the success and failure of a bailout. Markets also have serious concerns about government involvement in the economy. Despite the fact that this a sometimes referred to as a bailout of Wall Street, the markets know that government aid does not come without strings attached. They are concerned about increasing government oversight and regulation. Also, the bailout will not give shareholder a get-out-of-jail-free card. The bailout agreement that saved AIG was not a boon to the average AIG investor, who still lost a great deal of money.

The final issue with regard to the bailout is the question of the moral hazard that all bailouts create. If the bank is bailed out, as happened with the savings and loans industry in the 1980s, will this lead to riskier behaviour by investors? Won’t investors feel that they can take on risk because if they get in trouble the government will just rescue them? There is something to be said about the moral hazard associated with bailouts, but the problem is sometimes exaggerated.

First, Wall Street is not getting off the hook completely: tough times are in store for everyone. Wall Street banks will not find the process easy and will expose themselves to more government involvement than they are comfortable with. The bailout gives the government a great deal of leverage, which most investors do not like.

Second, the logic of moral hazard in general is often taken too far. For example, with regard to air bags in cars, it could be argued that since people are more likely to survive a crash thanks to them, they will be more likely to drive recklessly. Thus airbags would lead to more fatalities, not fewer. This could be extended: perhaps instead of air bags cars should have steel spikes installed in the steering column designed to deploy in case of an accident, thus ensuring that even minor collisions are fatal. This is the only way that drivers can be forced to drive safely! The problems with this logic are obvious.

In terms of actual modifications made to the original bailout proposal, some are significant and deserve particular attention. First, the funds will be issued in stages. The Treasury will receive US$200 billion in the first installment. In terms of the size of the problem, this amount is not very big. This provision is also reminiscent of the terms attached to IMF lending, which is dispensed in stages in order to minimize the risk of moral hazard and to make sure the IMF does not lose control of the bailout agreement.

The second modification is a limit imposed on CEO compensation, especially ensuring that no one receives any golden parachutes. This is intended to make the bailout more politically palatable. It is not irrelevant, but it is not crucial to solving the problems in the financial system. CEOs are paid a lot of money but a few hundred million here or there will not save the economy. Also, as many people have pointed out, this is something the CEOs will likely find creative ways of getting around.

The third modification is the introduction of oversight through two boards. The Financial Stability Oversight Board is composed of key figures in administration including the Treasury secretary, the chair of the Federal Reserve, the chair of the Securities and Exchange Commission, the Federal Home Finance Agency director and the Housing and Urban Development secretary. This board will ensure that the bailout plan is implemented in such a way that it protects the interests of taxpayers and is in the economic interests of the United States. Congress will also create an oversight panel of five outside experts appointed by the House and Senate. This panel will review the state of the financial markets, the regularity system and the Treasury’s use of its authority under the rescue plan.

The fourth modification is a direct attempt to protect taxpayers. This requires the president to propose legislation that will help recover losses from the financial industry in the event that the rescue plan results in a net loss to taxpayers five years after it is enacted. Although this provision is not meaningless, it is hard to see at this point how it will be enforced. The modification also
includes a provision that allows the Treasury to take an ownership stake in any participating company in order to ensure that taxpayers’ money is recouped.

The final modification is also a provision insuring against losses from the rescue plan. This forces financial institutions to pay risk-based premiums for an insurance policy, which will be activated in case they are unable to repay the Treasury. There is merit to this provision, but it also goes against the overall logic of the bailout: it requires those companies with the greatest liquidity problem to pay the highest premiums.

These provisions are an attempt to simultaneously stabilize markets and minimize political fallout. This is, of course, not an easy thing to do and, as a result, these modifications to the Treasury’s original proposal do not satisfy anyone completely. Wall Street is worried about a watered-down rescue plan with a lot of political provisions. Various political groups in the U.S., from free market advocates who are against government involvement to those worried that the bailout plan is helping the wrong people, are not happy. This Main Street versus Wall Street debate is not a uniquely U.S. phenomenon, and will likely emerge once again when a reform package is discussed among the G7. Right now three of the countries in the G7 are facing elections: the U.S., Japan and Canada. Although the current financial crisis is not a major issue in Canadian politics, it is on the political radar screen. Since all members of the G7 are democratic countries, voter concerns will play an important role in most crisis-reform efforts.

Impact and Post-Crisis Reform

There remain four important issues to address here: the balance between governments and markets, the future of the norm of embedded liberalism, the limitation of reform through regulation and the actual prospects for meaningful reform in the post-crisis environment.

A crisis such as this one, with its complex origins, provides ammunition to support any almost any ideological view. On the one hand, there are growing concerns about unrestricted markets and, especially, the lack of regulatory oversight. The idea that markets do not need government regulation and can provide their own oversight is problematic. Markets have failed to self-regulate, not just in the current crisis but in past ones as well. The most prominent case of this is the Enron scandal of a few years ago, which showed that private sector oversight, by supposedly independent audit firms, was subject to the same dangers of capture and conflict of interest that have plagued public regulation. Although excessive regulation is dangerous, complete deregulation is not the answer.

Similarly, there is a danger of reining in markets too much. A great deal of prosperity has come out of markets and the internationalization of investment. Even if markets have to be limited, there are practical problems in trying to impose greater restrictions in the short term. Despite the worries by some that the U.S. faces the prospect of socialism, Wall Street would be the first to oppose any such attempts. The real issue is not a choice between government intervention in the economy and free markets, as some contend, but the need to find an appropriate balance between the two.

Another significant issue that some have been worried about for some time now is whether international interaction, particularly in the realm of the economy, is still governed by the norm of embedded liberalism. The idea of embedded liberalism was first proposed by John Ruggie who argued that the post–World War II economic system created at Bretton Woods was governed by this principle and that economic relations are still governed by it. This norm, according to him, helped ensure that states could capture the benefits of the free market while at the same time avoid the danger of becoming subservient to it. In effect, as Ruggie notes, the liberal market was embedded in the society and thus served the needs of society and not the other way around, as was the case under the classic gold standard. At the same time this also helped avoid the danger
of economic nationalism and beggar-thy-neighbour policies that characterized the inter-war period.

This norm is still alive today and will remain relevant despite concerns over the rise of neoliberalism or economic nationalism. The forces that first created a need for embedded liberalism – the benefits that free markets confer on society and the negative impact that unrestricted markets can have – are still around today. They are there in the benefits and danger of the current process of globalization. They are also in the debates that are taking place about what needs to be done to effectively deal with the current subprime mortgage crisis. As already noted, the bailout effort is being shaped by two forces powerful forces: markets and domestic politics. For the bailout and the post-bailout reforms – and any economic policy for that matter – to be effective, there must be a balance struck between the needs of markets and domestic politics.

Regulation is not a magic bullet that will end crises once and for all. No such solutions exist!

There are four reasons to guard optimism about what regulation can do.

First, markets are constantly changing and regulators are always trying to catch up. The old cliché that generals are always preparing to fight the last war to financial markets can be applied here, as it is just as true that regulators are always preparing to prevent the last crisis. Even a very traditional sector such as the mortgage industry can produce surprises. Yet no one should have been surprised by the current crisis, although there are still some aspects that make it very different from past real-estate bubbles. The development of new financial instruments – the so-called securitization of mortgages – led to the spread of the crisis to Wall Street and nearly every developed financial market. It also played a role in bad investment decisions by partially obscuring of the risks involved – that is, in a number of cases investors thought they were buying much safer investments that was actually the case.

But even when regulators identify a problem ahead of time, it is not always easy to know what needs to be done. And even if it is, regulators and policy makers can still lack the political will necessary to take steps to correct the problem. This leads to the second problem with regulation, namely that there are serious limitations to what it can actually achieve. In the private sector the recent accounting scandals have shown that there is always potential for a conflict of interest with any regulatory institutions. With government regulation this problem is even greater. After all, there is remains the question of where regulators come from. They usually come from the industry they regulate, or they wish to enter it once they leave the public sector. So if a regulator is too tough, his or her future employment prospects are not very bright. Similarly a politician who decides to intervene in a booming financial market because of worries that the apparent economic bonanza is just a price bubble faces political risks. The political benefits of “ending the party” are few. The cost, in terms of lost votes and campaign contributions, are significant and immediate.

The third issue is what kind of regulation is optimal. Regulation is often thought of in terms of imposing rules and government intervening to stop unacceptable behaviour. However, equally important, if not more so, is the promotion of transparency and disclosure in an industry. These allow people to make informed decisions, which should be more effective and less costly and controversial. There was an unacceptable lack of transparency in many parts of the U.S. mortgage market. There is evidence that some people were fooled into contracts they did not understand. In fact, to date the FBI has made around 500 arrests in connection with the mortgage scandals. But more could have been done to let people know what they were getting into beforehand. Many ordinary people and even financial institutions did not understand the risks of mortgage derivative securities.

A final problem with turning to regulation as a solution is the issue of political will. A crisis generally produces a lot of political will, both at the domestic and international levels, in favour of reform and better regulation. But as time goes on, this political will slowly dissipates. The best analogy to this situation is waking up with hangover after a night of heavy drinking. Your head hurts and you know you went too far. So you solemnly decide that from now on you will only
drink in moderation. But a few weeks go by and you have one more drink than you usually do with no ill effects. One drink leads to another and so on … and suddenly you are drunk again and all bets are off. The next morning you are predictably hung over again and you say to yourself no more excessive drinking – this time with firm conviction. The danger with reform efforts that are too radical and try to do too much is that eventually markets and government will begin to ignore them. Markets do not like speed bumps and try to find ways around them once they regain their confidence. Similarly governments are usually lax in enforcing such restrictions in times of prosperity.

In closing, the point is not that reform and regulation are unrealistic. In fact, they are absolutely necessary and should be the focus of the efforts of national, multilateral and international financial institutions once the crisis is over. However, at the same time, it is important not to set expectations too high. There is not a new Bretton Woods system being considered. Such a radical transformation of the international economic system is unrealistic. Nonetheless, this is a chance to fix a number of problems that have plagued the international system for some time, in the area of international finance as well as with regard to other economic issues as well. There is a chance to make up for the lost opportunity of the 1970s when similar problems arose. Many of the reforms will be technical, and they will depend crucially on international cooperation and coordination for their success. This is why the international financial institutions such as the IMF and smaller forums such as the Bank for International Settlements and the FSF are going to be crucially important. This current crisis is an important test of embedded liberalism. Getting the G7 members to coordinate their efforts will be crucial. This is not one country’s problem; it is a systemic problem. But fixing it will not be easy, and each government has its own idea of what needs to be done, as do markets and domestic political groups. Reform efforts will not satisfy everyone but must still be guided by multiple perspectives and allow for individual variation where possible and a united front where necessary.