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LSE public lecture

The Financial Crisis: Who is to Blame?

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Director, LSE

Robert Peston
Business Editor, BBC

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Old Theatre

28 September 2010

Why bother?

- This failure has many parents, some illegitimate

- There is a serious risk of displacement activity, and false comforts

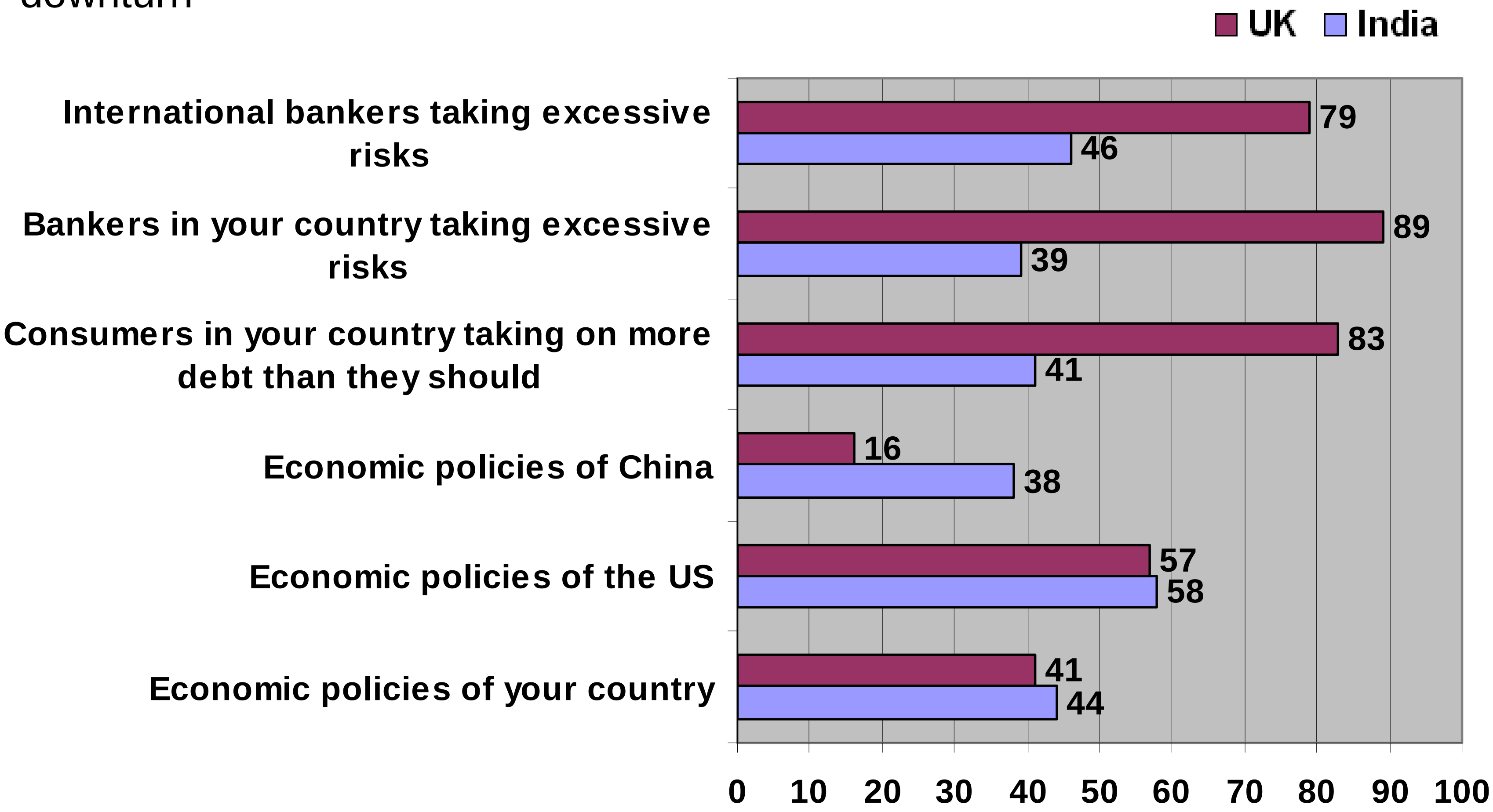
- The economic and social costs have been enormous: Global unemployment estimated to be 15 million higher than before the crisis

Les français croient que les plus coupables sont:

- Les établissements bancaires américains
- Le gouvernement américain
- Les établissements bancaires en général
- Les grands dirigeants d’entreprise
- Le système capitaliste

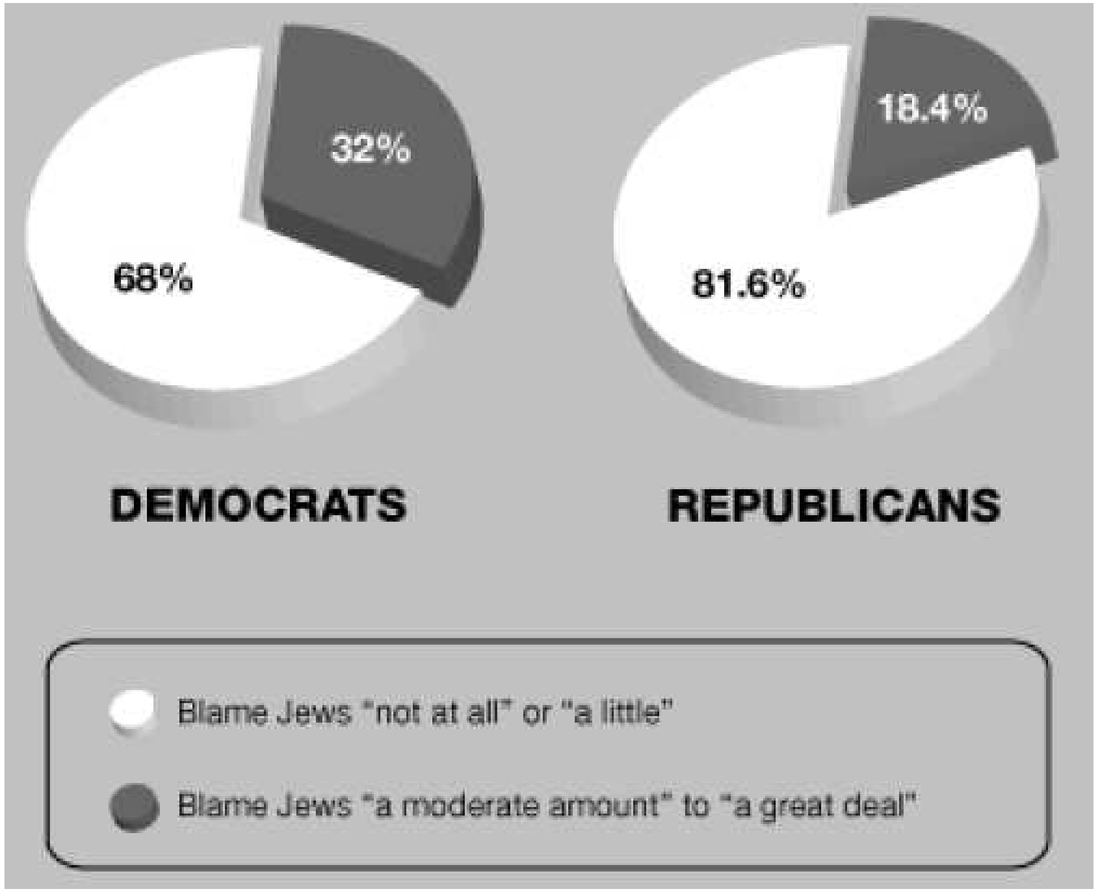
Who is to blame for the current financial crisis?

% of respondents answering “a lot” to the given statement: “For each one please tell me if you think it has contributed a lot, some, or not at all to the downturn”

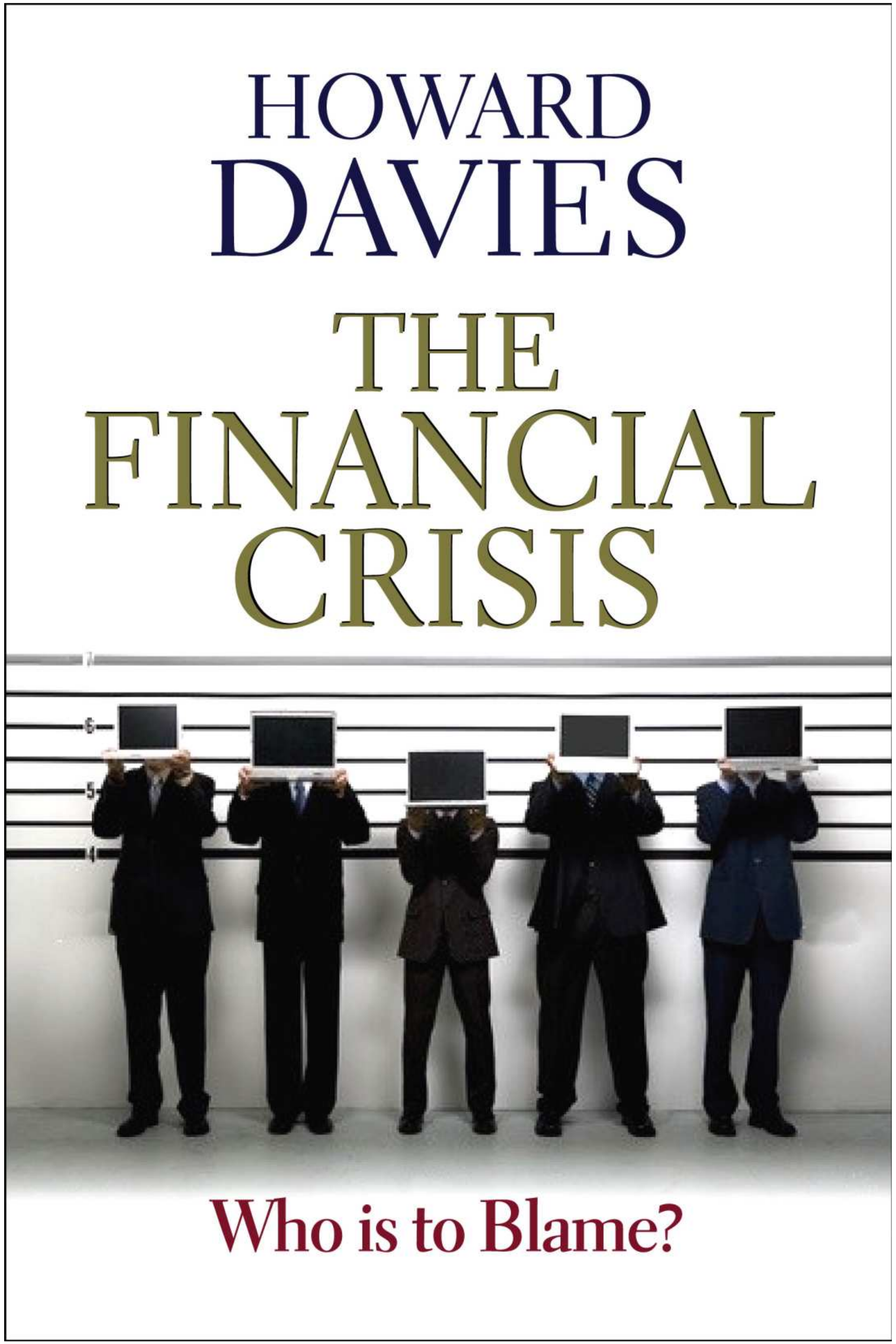


Source: WorldPublicOpinion.org. Public Opinion on the Global Economic Crisis, 21 July 2009.

Who blames “the Jews” for the financial crisis?



Source: N Malhotra, Y Margalit: State of the Nation. Boston Review, May/ June 2009.



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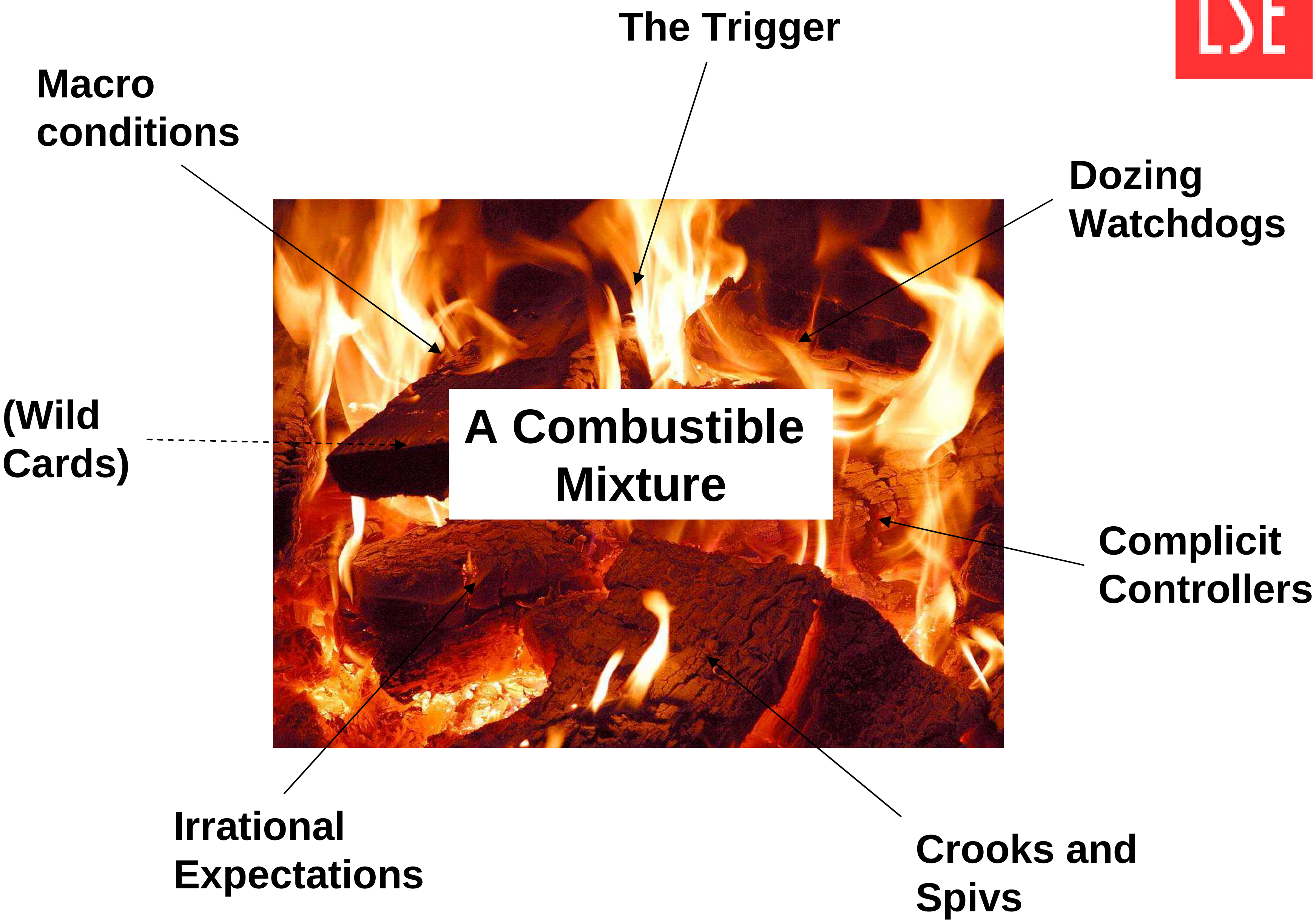
To avoid mis-selling, the book is not

- A Hutton tirade
- A Peston polemic, or
- A patent remedy


The Trigger
Macro conditions
Dozing Watchdogs
(Wild Cards)
A Combustible Mixture
Complicit Controllers
Irrational Expectations
Crooks and Spivs

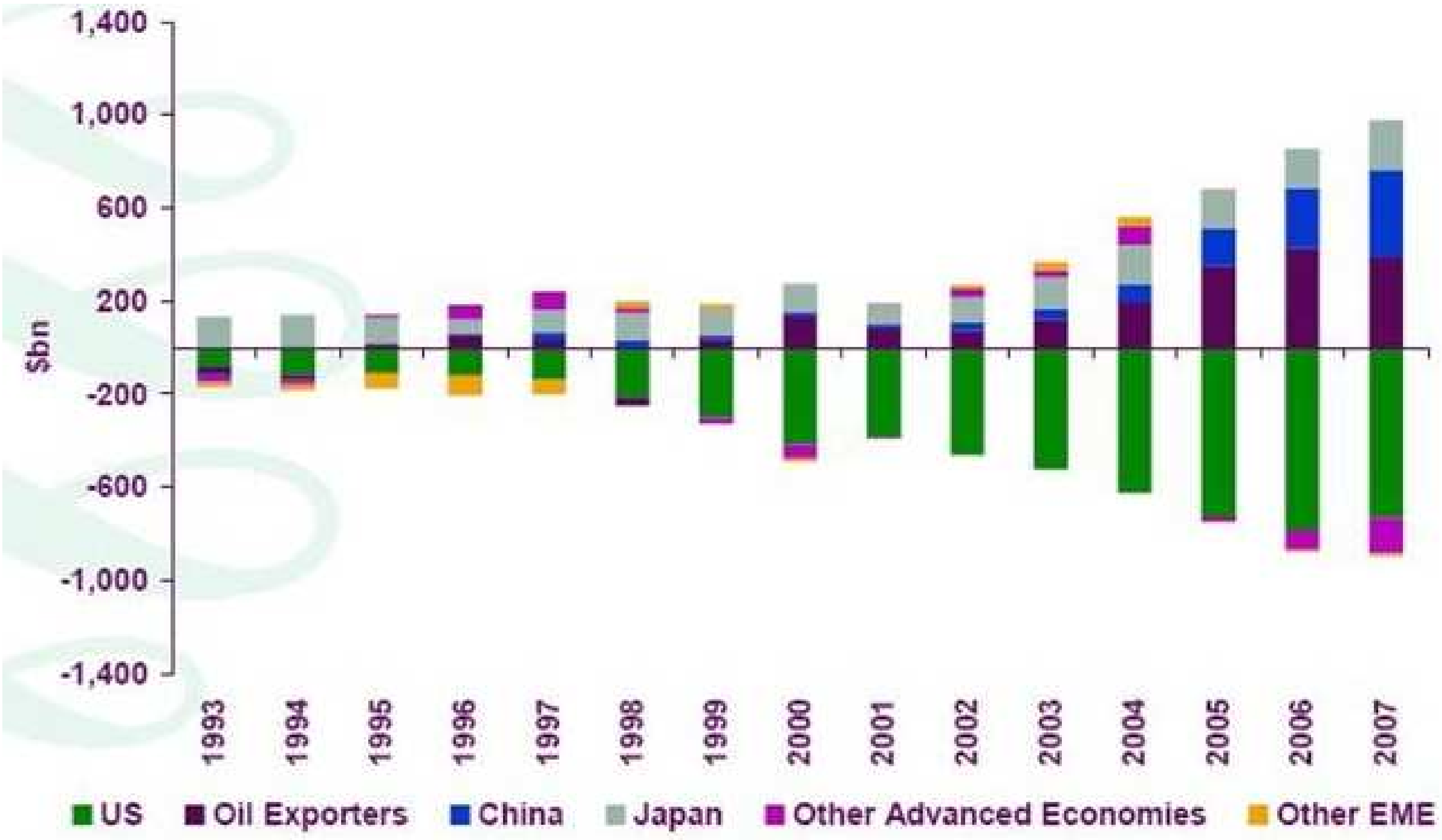
Macroeconomic conditions

"It is impossible to understand this crisis without reference to the global imbalances in trade and capital flows which began in the latter half of the 1990s."

Ben Bernanke

Global current account imbalances grew rapidly from 2003

Estimates of account balances for selected countries ($ Billion), 1993-2007



Source: Datastream, FSA Calculations.

Monetary Policy: Too loose?

“Clear evidence of monetary excesses during the period leading up to the housing boom”

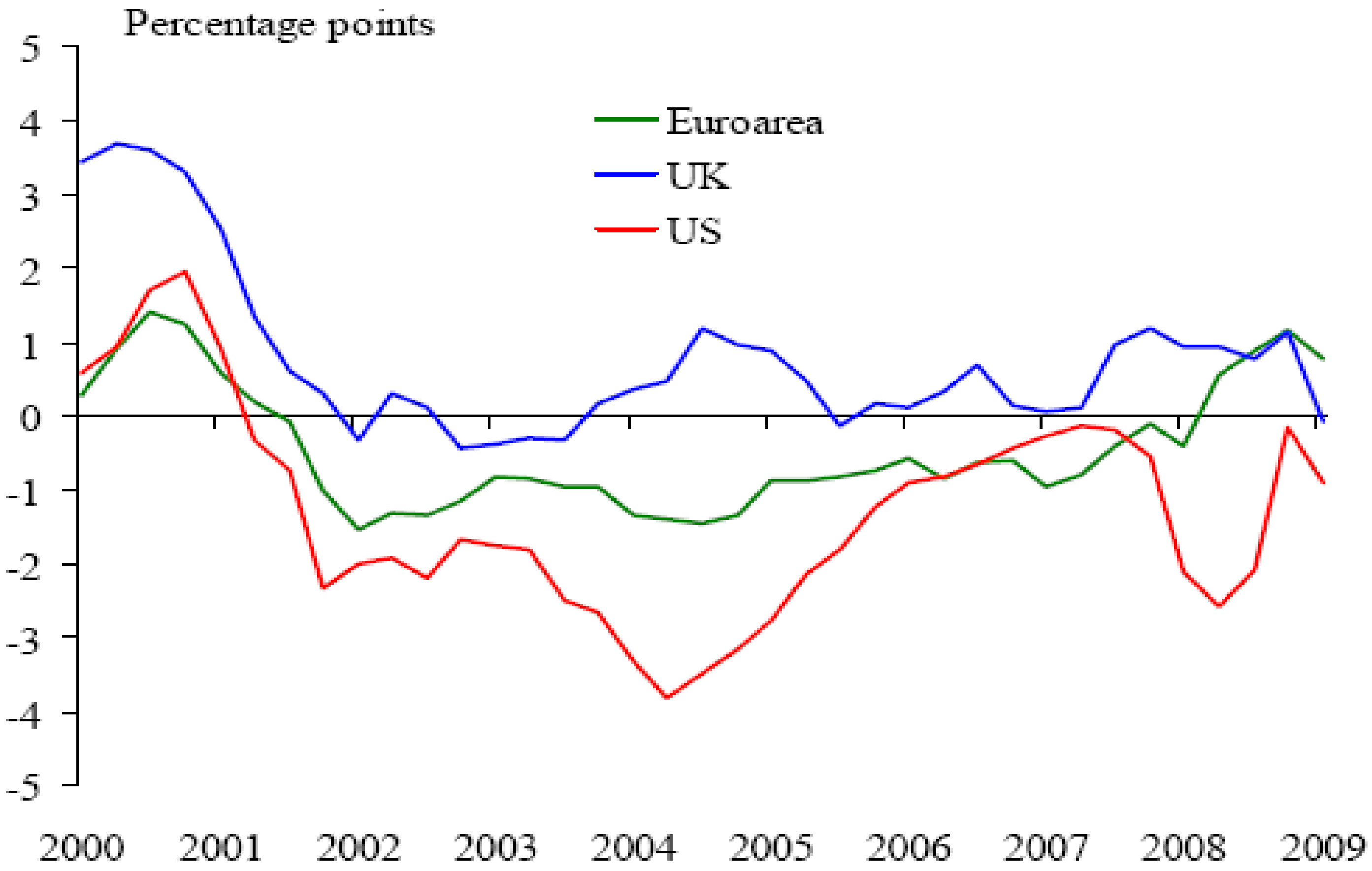
John Taylor

“It was long-term interest rates that galvanized home asset prices, not the overnight rates of Central Banks”

Alan Greenspan

Monetary policy was loose, especially in the US

Deviation of policy rates from Taylor rule (%), 2000-2009



Source: Bank of England, Speech of Charles Bean at the Annual Conference of the European Economic Association, 25th Aug 2009.

Forever blowing bubbles: Three views

1. Mopping up

   “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.”

   Alan Greenspan

2. Leaning against the wind (with monetary policy)
3. Macroprudential mechanism (capital ratios)

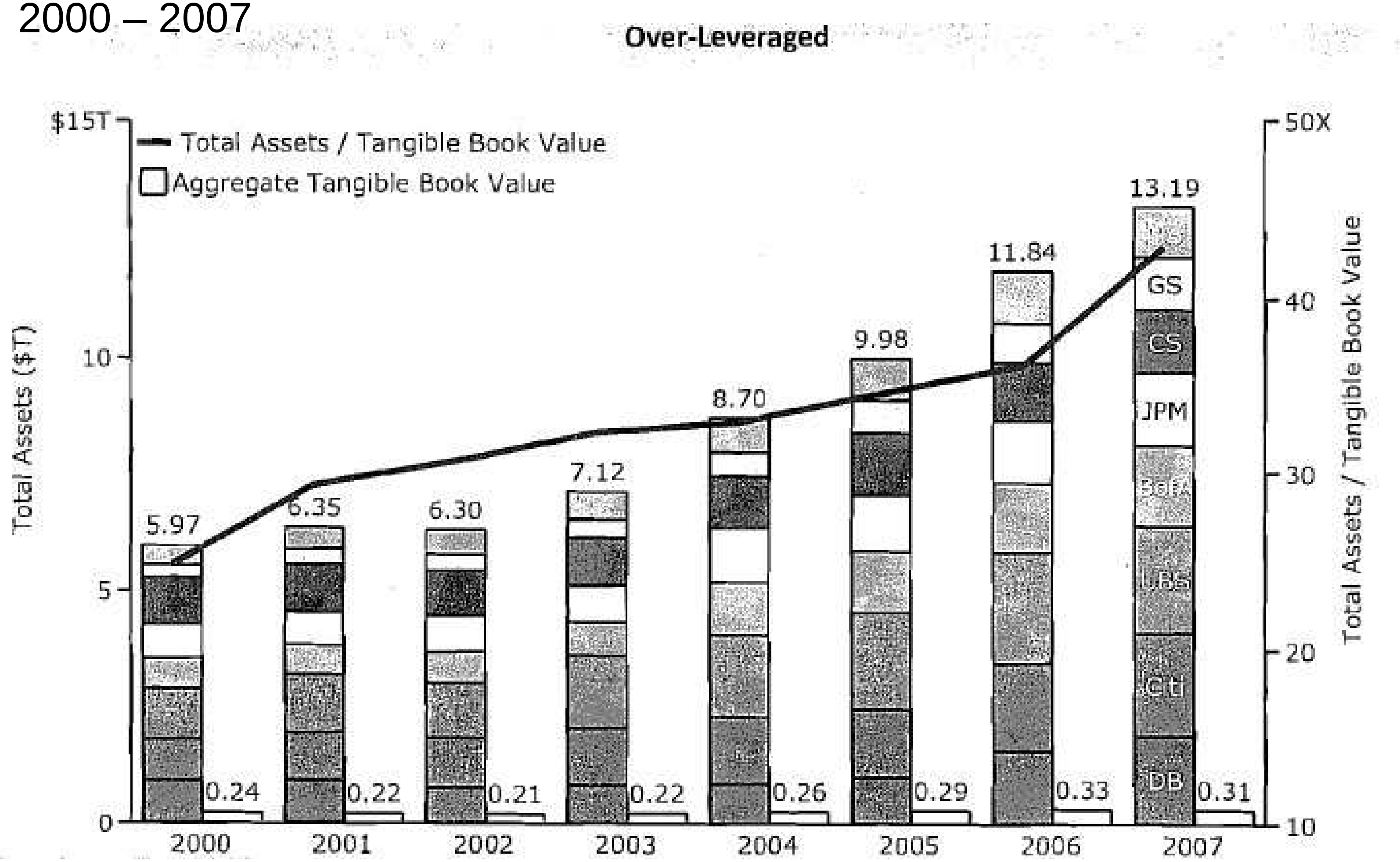
Leverage is a favourite one-word answer. But why did it grow?

"The negative impact of stagnant real incomes and rising income inequality on aggregate demand was largely offset by financial innovation in risk management and lax monetary policy that increased the ability of households to finance consumption by borrowing."

Joseph Stiglitz (UN Report)

Bank Balance Sheets expanded

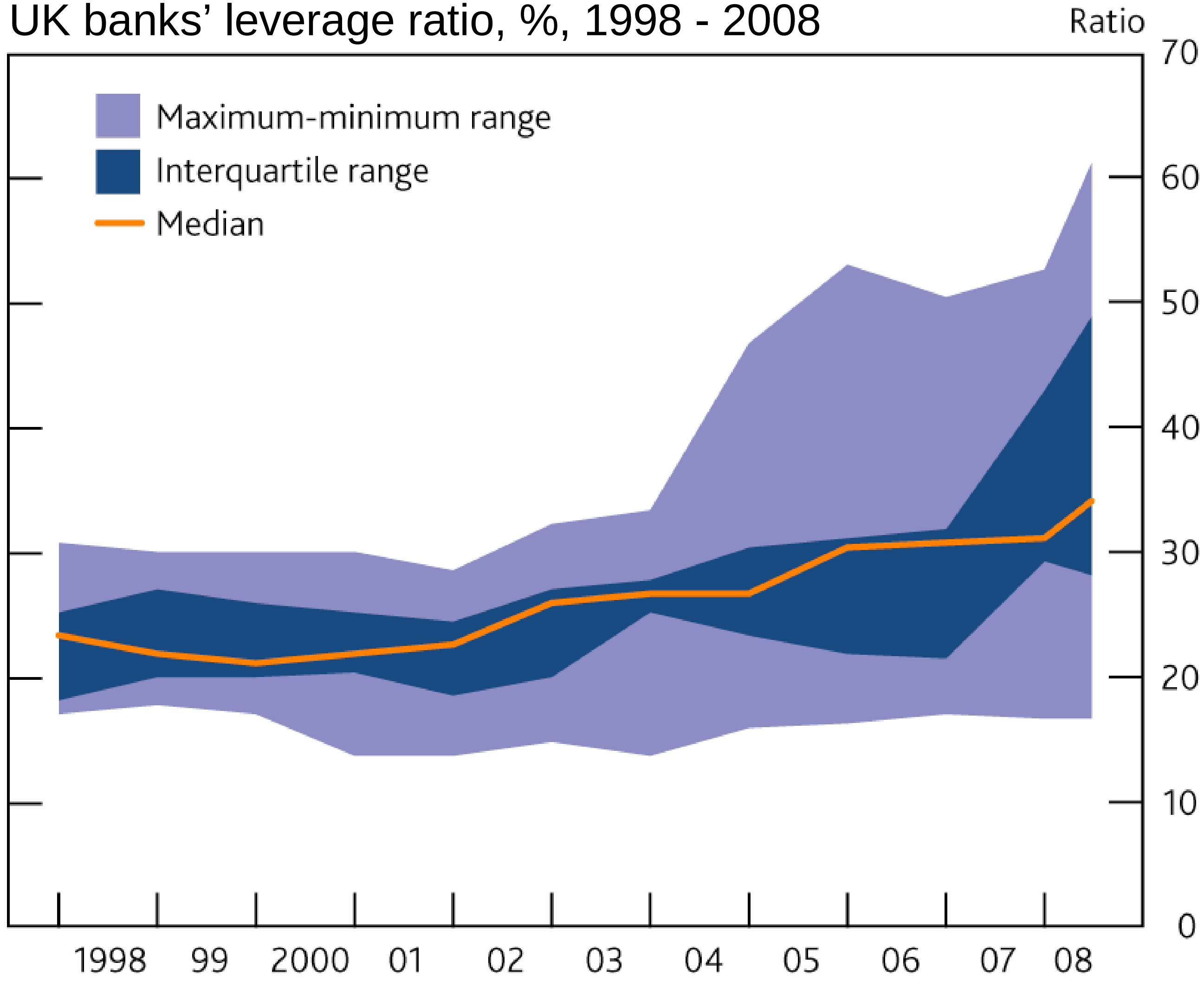
Large-cap banks' aggregate assets rose to 43x tangible book equity, 2000 – 2007



Source: Silverlake, Capital IQ.

UK banks leverage grew sharply from 2003 onwards

Major UK banks' leverage ratio, %, 1998 - 2008



Note: Leverage ratio defined as total assets divided by total equity excluding minority interest. Excludes Nationwide due to lack of interim data.

Source: Bank of England, Financial Stability Report, Issue 24, 28 October 2008.

7. **A capital shortage:**

The charge:

Banks were allowed to operate with too little capital. Leverage grew, and revenues were inadequate to cover losses when asset prices fell.

The response:

'Basel 3' will increase tier one capital sharply (2 – 7 percent), triple capital in the trading book, outlaw 'soft' capital and strengthen balance sheets generally. BUT will the reforms damage the system and make credit scarce and too costly?

8. Procyclicality:

The charge: The capital rules tended to accentuate the cycle, allowing banks to hold less capital as asset prices rose, as back-testing revealed low losses and loss given default over previous years.

The response: Macro-prudential requirements – which will allow regulators to tighten capital in anticipation of price bubbles bursting – 'leaning into the wind'. Stress-testing. BUT how do we know when there is a bubble? Why not use interest rates ?

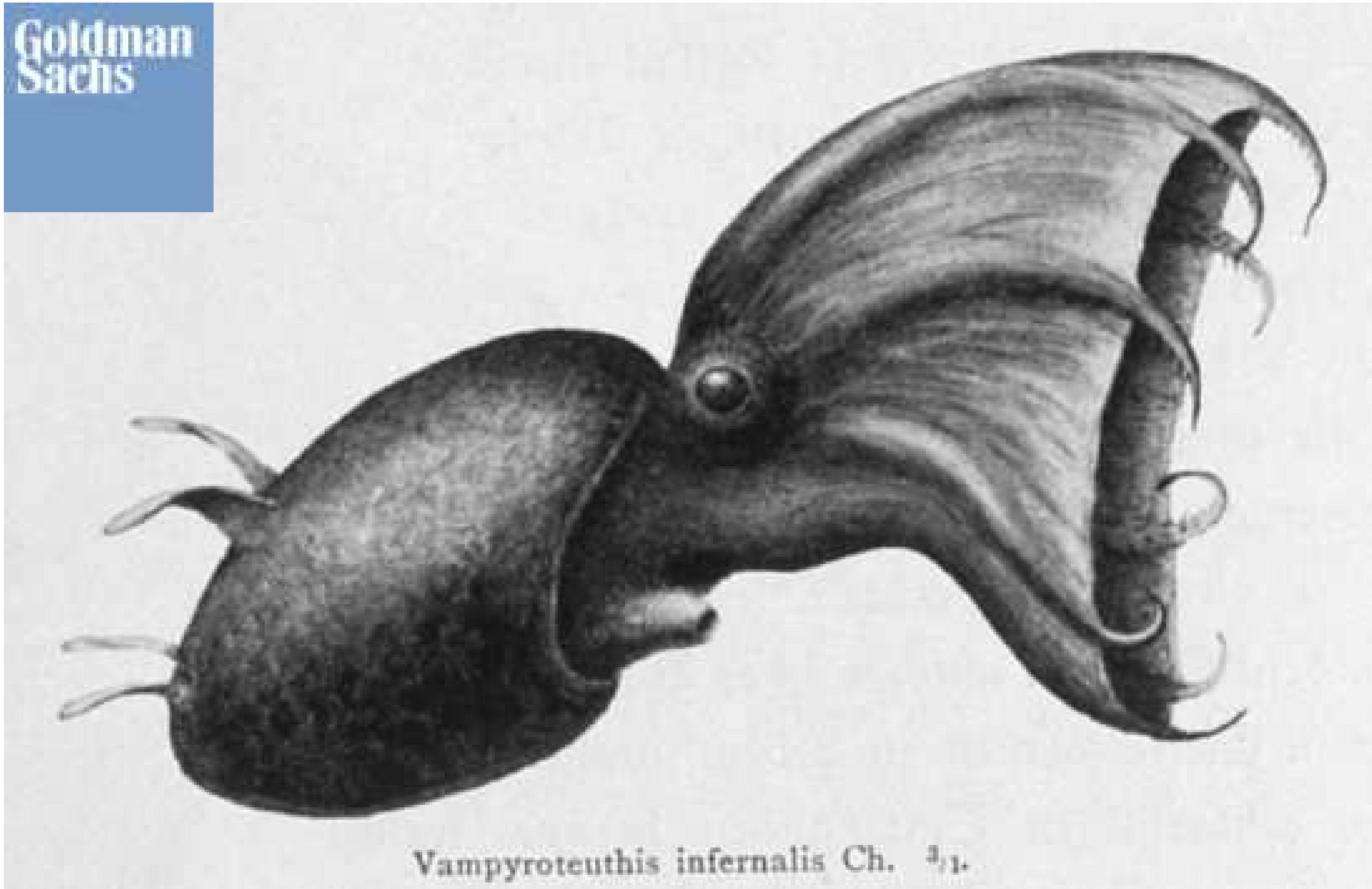
Complicit Controllers

21. Shoot the Messenger: Fair Value Accounting

22. Tunnel Vision: The Auditors

23. Conflict of Interest: The Credit Rating Agencies

***Rolling Stone* described Goldman Sachs as "a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money."**



Vampyroteuthis infernalis Ch. 2/1.

Crooks and Spivs

"What happened to compensation and the incentives in creative risk-taking did contribute in some institutions to the vulnerability that we saw in this financial crisis."

Tim Geithner

"While inappropriate remuneration structures played a role they were considerably less important than … inadequate approaches to capital, accounting and liquidity."

Adair Turner

"There is no evidence that banks with CEOs whose incentives were better aligned with the interests of their shareholders performed better during the crisis and some evidence that these banks actually performed worse."

Fahlenbrach and Stulz (NBER)

"(Bankers) have incentives to give insufficient weight to the downside of risky strategies. … equity-based compensation could be replaced with compensation based on the value of a broader basket of securities, including bonds."

Bebchuk and Spamann

Irrational Expectations

"Economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth. … They turned a blind eye to the limitations of human rationality that often led to bubbles and busts."

Paul Krugman

"The unfortunate uselessness of most 'state of the art' academic monetary economics."

Willem Buiter

"There have been business cycles for centuries, some mild, some even severe. Why should the current one be expected to alter the views of the Chicago School?"

Anna Schwartz

"I simply see no connection between the reality of the macroeconomics that these people represent and the caricature provided by the critics."

Robert Lucas

Inefficient Markets

"The prevailing misconception was the belief that financial markets are self correcting and should be left to their own devices."

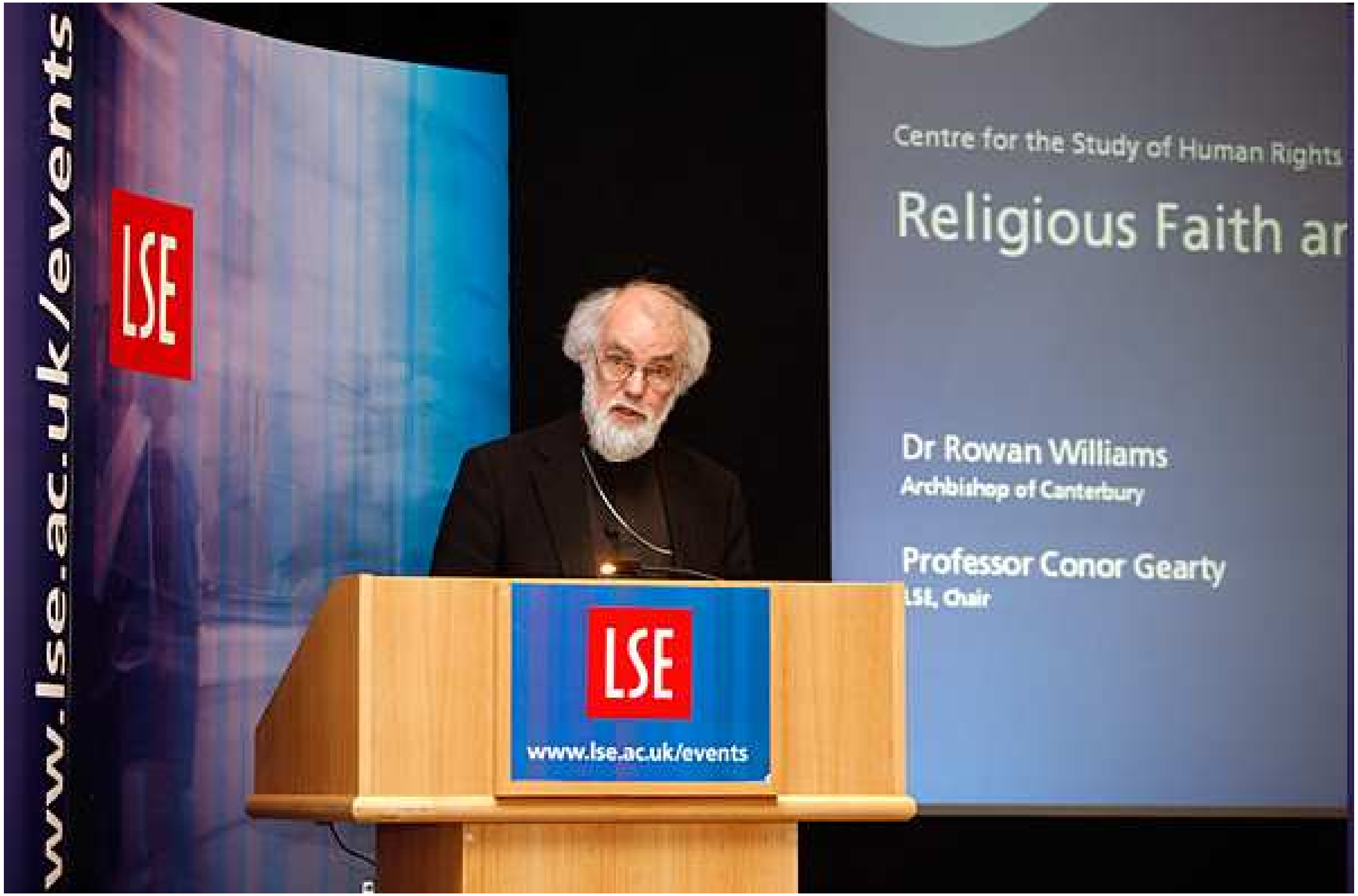
George Soros

" Most investing is done by active managers who don't believe markets are efficient."

Gene Fama

"Behavioural finance… consists of a set of disjointed and inconsistent ideas… . The impact of the theory of efficient markets has proven to be durable."

Ray Ball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Religious Faith ar
Dr Rowan Williams
Archbishop of Canterbury
Professor Conor Gearty
LSE, Chair
LSE
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36. Greed

"As religious leaders we want to say that the root of it is human greed."

Rowan Williams

"Greed is simply the compulsion that helps antropomorphise the capitalistic spirit."

The Market Oracle

The homeostasis of the reward/ loss system was thrown out of balance: "all perception of risk was removed and therefore untrammelled greed took over in investors' brains … this greed stimulated a moral meltdown in the marketplace."

Forum on Public Policy:
The Oxford Round Table

38. Hormones

Is the crisis a ‘Boy Thing’?

‘risk-taking in an investment game with potential for real monetary payoffs correlates with salivary testosterone levels’

(Scientific American)

Maybe, but

- the presence of women on the trading floor may ratchet up testosterone levels among men, and

- “during menstruation, when levels of oestrogen and progesterone are the lowest, women do not bid differently from men”

(Centre for Economic Research and Graduate Education)

So where are we now?

	Problems	Non-Problems
Solved	Bank Capital (Quantum) Regulatory Arbitrage Derivative Transparency Liquidity Bankers Incentives	Hedge Funds (EU) Short Selling (EU) Prop Trading (US) UK Regulation
Unsolved	Global Imbalances Income Inequality Monetary Policy (Financial Stability) Bank Capital (Countercyclical) US Regulation	Offshore Centres Fair Value Accounting

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