Real Causes of the Financial Crisis

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Monetary policy and the crash

- Fed Funds Rate was cut from 6.25% to 1.75% in 2001.
- It was cut further and held at 1% until mid 2004.
- The real Fed Funds Rate was negative for two-and-a-half years in the period 2002-2004.
- A Taylor Rule would have led to a Fed Funds Rate between 2% and 5% during 2001-2005.
- Money supply was growing rapidly at 14.1% per annum in September 2007.

Reinforcing moral hazard

- Fannie Mae had a commitment to spend $2trillion expanding home ownership amongst low-income earners and minorities.
- 40% of loans Fannie Mae bought and securitised in 2007-2008 were sub-prime, or Alt-A loans
- Weak personal bankruptcy law
- The absence of proper risk premiums in deposit insurance systems
- Continual bailing out of the US financial system (savings and loans in the 1990s, LTCM, and so on).
- "Greenspan put"

Unintended consequences of regulation

- Community Reinvestment Act
- Encouragement of floating rate mortgages
- Basel capital requirements and the ratings agencies
- US response to Basel capital requirements
- Institutionalising systemic risk – the Basel Accord
- Tax and equity capital

Public choice

- Regulation can be driven by incentives bureaus:
  - Regulators may discharge their duties by “writing rules”
  - They will try to ensure that “something is done”
  - They will be risk averse, trying to reduce the number of failures on their watch
- If a failure does happen, the regulator may be slow to act in the hope that recovery will happen
- Regulatory capture

What should we do?

- Risk-based deposit insurance
- Make depositors senior creditors
- Living wills
- Other legal mechanisms to ensure orderly failure
- Banks should publish more detail of their exposures *to the market*
- Contingent capital
- Reform equity taxation
- Capitalism requires orderly failure!