The Wayback Machine - https://web.archive.org/web/20090711193217/http://blogs.ft.com:80/economistsforum/2009/07/economic-witch-hunting/

FINANCIAL TIMES All times are London time

ft.com/economistsforum

Economic witch-hunting

July 8, 2009 4:54pm by FT

By Ricardo Caballero

Perhaps one of the economic phenomena most akin to witch-hunting is the diagnostic and policy response that develops during the recovery phase of a financial crisis. Understandably, pressured politicians and policymakers rush to find culprits and sources of instant gratification. All too often they find a ready supply of these in preconceptions and superficial analyses of correlations. This time around the scapegoats are global imbalances and leverage.

Global imbalances are the victim of preconceptions: Many economists and commentators argued before the crisis that large global imbalances would lead to the demise of the U.S. economy once capital flows decided to run en masse, as often happens with the sudden stops that afflict emerging market economies. The crisis indeed came, but rather than destabilizing the US economy, capital flows helped to stabilise it, as flight-to-quality capital sought rather than ran away from US assets. (There was a reallocation from private to public assets which was indeed very destructive, but it had little to do with the distinction between foreign and domestic assets highlighted by the sudden stop camp.)

The fact that the actual mechanism behind the crisis had nothing to do with that which was used to explain the forecast of doom has long being forgotten, false idols have been erected, and new gurus roam the land. Along the way, global imbalances have been indicted for witchcraft, and ever more exotic rebalancing and currency proposals make it to the front pages of newspapers around the world.

Leverage is the victim of superficial analyses of correlations: In my view one of the main factors behind the severity of the financial crisis was the excessive concentration of aggregate risk in highly-leveraged financial institutions. Note that the emphasis is on the concentration of aggregate risk rather than on the much-hyped leverage. The problem in the current crisis was not leverage per se, but the fact that banks had held on to AAA tranches of structured asset-backed securities which were more exposed to aggregate surprise shocks than their rating would, when misinterpreted, suggest.

Thus, when systemic confusion emerged, these complex financial instruments quickly soured, compromised the balance sheet of their leveraged holders, and triggered asset fire sales which ravaged balance sheets across financial institutions. The result was a vicious feedback loop between assets exposed to aggregate conditions and leveraged balance sheets.

The distinction emphasized in the previous paragraph may seem subtle, but it turns out to have a first order implication for economic policy design. The optimal policy response to this problem is not to increase capital requirements (or to deleverage), as the current fashion has it, but to remove the aggregate risk from systemically important leveraged financial institutions' balance sheets. This should be done through prepaid and often mandatory macro-insurance type arrangements, which can accommodate valid too-big or too-complex to fail concerns, but without crippling the financial industry with the burden of brute-force capital requirements.

In summary, it is not global imbalances or leverage that need to be reined in. Instead, the key imbalance was in the massive demand for AAA-instruments from all parts of the world (including US money market funds and other domestic institutional investors) which the US financial sector was unable to produce regardless of how much aggregation and tranching contortions it used to fit the task. More precisely, the financial sector can produce it, but not during severe crises, and it is this specific gap that needs to be fixed with pre-arranged public support and paid for up front.

July 8, 2009 4:54pm in Capitalism, Credit squeeze, Crisis, Fiscal policy, Recession, Regulation, Securities | Comment

Help • About us • Sitemap • Advertise with the FT • Terms & Conditions • Privacy Policy • Copyright
© THE FINANCIAL TIMES LTD 2009 FT and 'Financial Times' are trademarks of The Financial Times Ltd.