

Eric Maskin, Nobel Laureate 2007

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Financial Crises

Why They Occur, What to Do about Them,
and Implications for the Investment Market

E. Maskin

Institute for Advanced Study

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- current financial crisis only latest in long sequence
- history of financial crises goes back hundreds of years
- probably crises will continue in future
 - each crisis somewhat different from predecessors
 - even if we fix mortgage loan market in U.S. (where current crisis started), something new will happen
 - even if anticipated, not all crisis may be preventable
- however, can devise mechanisms to *limit* crises

Today's topics

- Why do credit and investment markets have repeated crises and other markets do not?
- Why do credit and investment markets require substantial *ex post* intervention (and others do not)?
- What can be done *ex ante* to prevent/limit crises?

Speak from perspective of theory of *mechanism design*

- theory shows how to reconcile conflicts between goals of private individuals/institutions and goals of society
- done through changing *incentives* of individuals and institutions
 - e.g. through taxes, subsidies, and regulations

To understand what caused current crisis (and others like it) should first eliminate factors that were *not* primary causes

- irrationality
 - on part of bankers
 - on part of investors
 - on part of borrowers
- panic
- greed
- unethical behavior
- overconsumption in U.S./ oversaving in China
- opaque derivatives
- bankers' bonuses
- banks too big to fail

Why are credit and investment markets different?

(1) credit and investment *lifeblood* of economy

- if crisis in market for potatoes, won't bring down market for automobiles
- if credit market doesn't work, enterprises in *all* markets will have trouble meeting payrolls and paying for inputs
- if investment market doesn't work, economy will stagnate - - no innovation

Why are credit and investment markets different?

- (2) small shock to credit or investment markets often *magnified*
- if some potato growers fail, won't cause other growers to fail
 - if some banks fail, may well cause other banks to go under
 - if some hedge funds get into trouble, others may get into trouble too

Why are credit and investment markets different?

- (3) credit and investment markets not *self-correcting*
 - if some potato growers fail, others will step into breach no outside intervention needed
 - if some banks fail, credit market can get “stuck” - - no banks willing to lend
 - similarly, with investment market

Elaboration on points 2 and 3

- Suppose lack of rain wipes out potato crop near Edinburgh
- What will happen?
 - immediate effect is fall in overall potato output
 - but demand hasn't changed - - fewer potatoes to go around
 - so price of potatoes *bid up*
 - induces other potato suppliers near Cornwall to grow and sell *more*

- So potato market “self-correcting”
 - crop failure hurts consumers in short run - - higher prices
 - but high prices induce suppliers to expand output
 - so effect of drought *mitigated* in long run
- Government intervention not needed
- Government interference in potato market likely to make things worse
- Suppose puts cap on potato price
 - discourages expansion of output that can make up for crop failure
 - this creates potato shortage or black market in potatoes

Credit and investment markets just the opposite

- Suppose a few banks get into trouble
 - made risky subprime mortgage loans
 - borrowers can't repay loans
 - banks highly leveraged – don't have enough capital to maintain other operations
- these banks have *other* borrowers
 - have to call loans in on these borrowers
 - so borrowers have to scale back activities that depended on these loans
 - thus will have harder time repaying loans from other *banks*

Credit and investment markets just the opposite

- so these other banks now get into trouble
 - have to call in loans from *their* borrowers
 - refuse to make new loans
- what started as *local* problem (subprime mortgage lending) spreads to *entire* credit market (systemic risk)
- initial problem *not* self-correcting (as in potato market)
 - gets *aggravated*
 - end up with *credit crunch*
 - not due to *panic*, but to *rational* responses by bankers and borrowers

- in economics terminology, bank exerts *externality* on other banks by being highly leveraged and making risky loans
 - externality: effect your actions have on others that you don't take into account
 - when bank highly leveraged and makes risky loans, puts other banks in jeopardy
 - but doesn't factor this effect in when leverages itself and makes loans (not harmed by it)
 - not *irrational* or *unethical* or overly *greedy*

- similar problem with investment/money-management market
- in recent years, investment increasingly *professionalized*
 - investment in stock market not made by *individuals*
 - but, by money managers (e.g., hedge funds)
- this has reduced investment *irrationality*
- but also created some *problems*

- hedge funds and other investment firms often *highly leveraged*
- for each investment firm, rational to be leveraged
 - get higher returns
- however, leveraged investment firm imposes externality on other firms (just as leveraged banks impose externality on other banks)
- markets with significant externalities often don't work well on own
 - take clean air, for example

- Why isn't there a market for clean air?
- in fact, there *is* such a market, but so limited we hardly see it
- suppose laundry next door to steel plant
 - smoke from steel plant interferes with laundry
 - laundry may offer to pay steel plant to reduce smoke (so market for smoke reduction exists)
 - but smoke doesn't just affect laundry - - affects many other enterprises
 - by paying for reduction, laundry confers benefit on other enterprises (externality)
 - laundry doesn't take this into account
 - so likely to *underpay* for reduction - - end up with too much smoke
- corrective mechanism: government imposes cap or fine on smoke emissions by steel plant

- for credit/investment markets, end up with too much leverage and too much risk
- chance of severe crisis too big
- Need *two* corrective mechanisms
 - *ex post* : *after* banks and investment firms get into trouble
 - *ex ante* : to prevent crisis in *first* place

Ex post mechanism:

If some banks or investment firms get into trouble,

- government can bail them out
 - infuse with capital so can continue to operate
 - or buy up their loans/investments
- but bailout important primarily for *other* banks or investment firms that would be hurt if bailed-out institutions failed

Bailout policy insufficient by itself

- unless occurs immediately, disruption to lending/investing
 - costly for economy
- so also need *ex ante* mechanism :
 - regulation
 - constraints on what banks and investment firms can do

- bank or investment firms ignores externality imposed on other institutions by risky loans/investments and leverage - - undervalues cost of these loans/investments and leverage for other institutions

Principal forms of regulation

- limits on leverage/capital requirements
 - given lending/investment, need minimum capital level
 - limiting leverage limits bank's or investment firm's liquidity
 - Obama Administration has proposed such limits
- minimum standards for loans
 - borrowers must be sufficiently creditworthy
 - Federal Reserve has power to impose standards (but failed to do so)

- restrictions on derivatives/securities
 - derivatives allow risks to be shared with others
 - risk-sharing useful
 - however, encourages riskier lending/investment
 - so, because of externality, should restrict derivative trading
- don't allow same risk to be hedged multiple times
(as in credit default swaps)

- correct incentives of rating agencies
 - need rating agencies
 - too costly to have each investor evaluate securities/derivatives on own
 - agencies should not be paid directly by parties whose securities they rate
 - instead could be financed from a fund paid into by these parties
 - track record of agencies should be publicized
(reputational mechanism)

- regulation of bankers' bonuses
 - many complaints about these bonuses
 - however, bonuses *per se* not problem
 - problem : rewarding bankers for success without punishing failure
 - encourages overly risky lending, which with leverage, imposes negative externality
 - solution : bankers should return bonuses (or suffer other punishment) if loans fail
 - Obama Administration recently proposed tax on bonuses
 - will not solve problem/done out of fairness
 - banks will simply raise bonuses/pass cost on to shareholders
 - does not address question of *when* bonuses awarded

- regulating size of banks
 - problem with big banks *not* too big too fail
 - several small banks failing has same effect as one big bank failing
- problem with big banks :
because of externality
 - bank takes too much risk
 - in particular, doesn't *diversify* sufficiently
 - so too likely to fail
 - small banks also too likely to fail
 - but several small banks less likely all to fail than one big bank, because each does something different (though perhaps not *very* different)

- have argued that can understand financial crises without invoking
 - irrationality
 - panic
 - greed
 - lack of ethics
 - opaqueness of derivatives
 - bonuses
 - too big to fail
- crises brought on by externality created by
 - risk-taking
 - leverage
- corrective mechanisms
 - bailouts
 - regulation

- Well-designed regulation/bailout package
 - can prevent many crises from getting started - - rules against subprime loans would have prevented this one
 - can resolve them if do occur
 - historically, regulation worked from 1940~1980
- Can't hope to prevent credit crises completely and still allow for creativity
 - can't anticipate all possible innovations by banks and money managers
 - so can't have rules that prevent only harmful innovations
- But can do a lot better than we've done this time