ACCF Seminar on the financial crisis: Professor Paul de Grauwe

On Monday 27 October 2008, the Amsterdam Center for Corporate Finance organized a seminar at which Professor Paul de Grauwe from the Catholic University of Louvain (B) gave his views on the origins of the credit crisis, the urgent measures to be undertaken currently by authorities and the long-term consequences. A selected group of bankers, supervisors, students and other interested persons were present at the Amsterdam Hilton Hotel. Below René Smits summarizes Professor De Grauwe's arguments.

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The causes of the present crisis

A central theme to the speaker was the issue of "moral hazard": insured agents will take more risks; this increase in risk taking should be counteracted by regulation and supervision. According to Professor De Grauwe, market players, authorities and academics have believed in the paradigm of efficient markets. This states that prices reflect fundamentals: neither bubbles nor crashes can be expected. In the words of former Fed Chairman Alan Greenspan, one should not interfere with "the pollinating bees of Wall Street". This unshaken but unwarranted faith in the paradigm of efficient markets led to reliance on the auto-regulation of financial markets, culminating in the repeal of the Glass-Steagall Act in 1999. (The 1934 Glass-Steagall Act provided for a strict division between investment banking and commercial banking.) Professor De Grauwe noted that this took place under a Democratic President (Bill Clinton) and a US Secretary of the Treasury (Robert E. Rubin) who, for 26 years, had worked at investment firm Goldman Sachs.

The free markets gave rise to a wave of financial innovation, mostly securitization, leading assets to be originated by banks and then distributed to ultimate investors through Special Purpose Vehicles. The sale of asset-backed securities increased financial institutions' capacity to grant more loans which, in turn, were securitized. Thus, the credit multiplier increased. The underlying assumption was that securitization led to improved risk spreading. However, as we have seen, it also led to increased risk spreading over the financial system, including that part which was outside of the control of central banks and supervisors. According to Professor De Grauwe, bubbles and crashes are endemic in capitalism. He showed graphs indicating an increase in corporate value on stock exchanges between July 2006 and July 2007 of 30% whereas GDP growth over the same period amounted to 5%. Then, a reversal took place, again without any link to underlying economic performance. Similar developments were shown to have happened on the NY Stock Exchange and NASDAQ, in the US housing market and on foreign exchange markets (USD/DEM and, alter USD/EUR). Professor De Grauwe called this 'collective madness': a wave of excessive optimism, followed by a wave of excessive pessimism, all part of the psychology of the markets rather than underlying economic fundamentals.

The present credit crisis is the result of uncertainty and herding behaviour. The deregulated banks, set free to invest in all kinds of assets, are now fully exposed to bubbles and crashes. The housing crisis in the United States was only a trigger not a cause and, therefore, is not to blame for the current crisis. If it hadn't been the subprime mortgages, another factor would have given rise to the same bursting of the bubble we now see.

Further elements contributing to the present crisis were the failures of rating agencies whose conflicts of interests made them give advice on products first and ratings on the same products later, and the marking-to-market accountancy rules. In respect of rating agencies, the speaker emphasized that the paradigm of efficient markets led people to believe, wrongly it now appears, that these private enterprises with reputations to discipline them (contrary to bureaucratic agencies) would not fail to perform correctly. The accountancy rules appeared to work pro-cyclical in inefficient markets: in the face of bubbles and crashes, marking to market undermines confidence. It leads to taking profits which did not correspond to real-economy profits and, now, to having to incur losses which do not correspond to real-economy losses either.

Finally, regulatory arbitrage played a role. Professor De Grauwe blamed Basel I with the low weighting attached to loans to other financial institutions. This led banks to grant short-term credit to SPVs and to increased reliance on the inter-bank market. This market used not to be guaranteed by governments, contrary to the deposit market. Also, Basel I gave a 0% weighting to government securities. This led to the development of the Credit Default Swaps market, where guarantees against the default of sovereign borrowers were developed. The CDS market developed, based on financial models of normal distribution of returns whereas returns are not normally distributed in free markets. They have 'fat tails': the bubbles and crashes inherent in capitalism. The speaker produced a graph which showed that a normal distribution of returns would lead to peaks and troughs that can be seen in financial markets over a decade, once in 7,000 years only. Thus, risk has been systematically under priced. Also, central banks were expected to act in case of liquidity squeezes, so that liquidity risks were not taken serious either.

Official responses to the crisis

Turning to the reactions of authorities, Professor De Grauwe noticed that a process of learning by doing is taking place. He was fully in favour of the liquidity provisioning by the central banks noting, however, that when the crisis began to unfold, certain central bank Governors were not yet convinced of the need to provide liquidity. His implied reference was to Mervyn King, Governor of the Bank of England, who had expressed fears about moral hazard just weeks before massive liquidity support in favour of Northern Rock. The speaker also noticed that central banks' balance sheets will be stretched by their increased liquidity activities. He shared with us a page from a recent IMF Financial Stability Report showing a massive increase of liquidity provisioning by the Fed, largely through new facilities.

On the government guarantees, Professor De Grauwe noticed the peculiarity that governments are now called in to save the markets. He questioned the credibility of guarantees on inter-bank deposits, drawing attention to banks' balance sheets in relation to GDP. He mentioned that the combined assets of the five largest banks far exceed GDP in the Eurozone and, in the Netherlands and Belgium, are even five times as large as these States' GDP. The situation is different for the United States, even though when all banks are included, the picture is somewhat less unbalanced. The speaker spoke of a "devilish interaction between the liquidity and solvency crises", with a liquidity problem leading to fire sales, and a drop in asset prices which, in turn, leads to a solvency problem. As long as this phenomenon continues, recapitalization of banks by governments is "throwing money into a black hole".

Summing up and questions

Professor de Grauwe saw a risk that the global process of deleveraging, i.e. shrinking of financial institutions' balance sheets, would lead to a depression.

Professor De Grauwe saw the possibility that governments may have to take over the whole banking system instead of just guaranteeing inter-bank deposits and re-capitalizing selected banks.

The speaker also saw the prospect of governments incurring massive deficits, with income decreasing and guarantees being invoked, whilst public spending is needed to give a boost to the economy. He was amazed how such an old-fashioned Keynesian idea returns as a recipe to help alleviate the crisis. This process will also increase the size of government debt. Sovereign debt will substitute private assets: there is a marked preference among investors for public instead of private debt.

Professor De Grauwe saw a need for price support by governments and central banks in order to help stock prices not go down further. He recalled how the Hong Kong Monetary Authority, in the 1990s, bought up large shareholdings in a remarkably successful effort to defeat a speculative attack on the Hong Kong dollar. In that case, the monetary authority of a fiercely capitalist society took large shares in local companies in pursuit of the public cause.

For the long-term, Professor De Grauwe saw a return of Glass-Steagall, with a strict division between investment and commercial banking, a prohibition for commercial banks to undertake securitization and a requirement that investment banks be funded on the capital market and not by commercial banks. He also found the Basle solvency arrangements defective. Banking will become less profitable but, also, less risky.

Asked whether he thought that we would see higher inflation, Professor De Grauwe agreed that governments may seek to reduce their indebtedness by fuelling inflation: this has occurred in the past.
In this respect, the multiple objectives of the Fed give the American central bank more leeway than the European Central Bank which, moreover, is faced with 15 different treasuries as counterparts. The ECB's overriding objective of price stability, its Treaty-given independence and the lack of agreement on economic policy among the Eurozone governments are marked differences with the US.

Professor De Grauwe agreed with one of the persons in the audience that central counterparties and officially regulated clearance of securities would be needed. Another speaker mentioned the lack of tough antitrust enforcement in the United States as one of the causes for the credit crisis. Asked whether the institutional setup of supervision on both sides of the Atlantic, with dispersed supervision in the United States (the SEC was responsible for overseeing investment banks and the regulatory landscape is divided) and in Europe (there is no central authority and there are at least 27 financial supervisors in the EU), Professor De Grauwe answered that the institutional arrangements may not have contributed to the seriousness of the problems but would certainly need to be modified. He argued for a single supervisory authority in Europe.

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