

# Grading Our Policymakers

*How effectively  
have they dealt  
with the root  
causes of the  
Great Financial Crisis?*

**B**lame for the Great Financial Crisis can be laid on many causes. Some argue that the crisis stemmed from severe global savings imbalances that led to the under-pricing of financial risk. The United States consumed too much and saved too little, while large parts of the world became dangerously export-dependent.

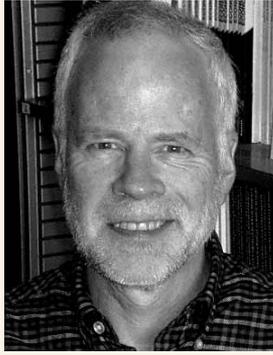
Others attribute the crisis to a lack of transparency in the asset-backed securities markets. Observers have cited the bank regulators and credit rating agencies for being asleep at the switch, along with the banks' inability to value the sophisticated

assets on their balance sheets even as they increased their use of financial leverage to dangerous levels. Then there was the alleged politicizing in the United States of Fannie Mae and Freddie Mac.

Some attribute the crisis to an overly accommodative monetary policy. The breakdown of Glass-Steagall and the growth of "too big to fail" institutions, which were able to engage in reckless financial risk-taking using taxpayers as their safety net, is also faulted.

To what extent have our policy leaders addressed these and other causes to prevent future crises?

**Two dozen experts offer their views.**



### *An Incomplete.*

**BARRY EICHENGREEN**

*Professor of Economics and Political Science,  
University of California, Berkeley*

**M**y own diagnosis of the crisis sees it as fundamentally the result of lax supervision and regulation of financial institutions and flawed incentives in financial markets. It was inadequate regulation that

sparked the flames: the Fed's exceptionally low interest rates in 2003–04 and the capital inflows into the United States associated with reserve accumulation abroad then poured additional fuel on the fire.

So in asking whether our policymakers have effectively dealt with the root causes of the crisis, I would look first and foremost at the steps they have taken to strengthen the application of existing regulations, promulgate constructive new regulations (Basel III), and correct the flawed incentives flowing from perverse executive compensation practices in the financial services industry. Here, I would give them a grade of Incomplete. I'm not so pessimistic as to believe that the window of opportunity has closed, but I've learned from years of teaching that the longer a grade of Incomplete remains on the books, the less likely the student is to complete the course requirements.



### *To date they deserve an A.*

**JAGDISH BHAGWATI**

*University Professor, Economics and Law, Columbia  
University, and Senior Fellow, Council on Foreign Relations*

**R**emedies must reflect, and readily follow from, diagnosis. Let me therefore concentrate on the many causes of the Great Financial Crisis.

Ideology played a role. The extraordinary belief, despite over a century of experience with panics, bubbles, and manias, that financial markets needed only notional regulation can be laid mainly at the door of former Fed chair Alan Greenspan. But there was also an unwarranted extrapolation to the financial markets of the successes we had in non-financial postwar liberalization of international trade and direct foreign investments.

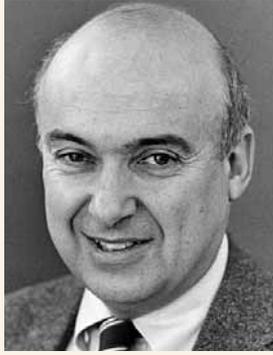
Another important cause was also what I called, in my 1998 *Foreign Affairs* article, the Wall Street-Treasury Complex. With continual back-and-forth movement from Washington to Wall Street, commonalities of viewpoint

followed, as did suspension of worries about the occasional downside in the financial sector. MIT professor Simon Johnson has picked up this theme, calling the Complex a "Corridor" instead and vulgarizing my idea by turning it into a "capture" proposition which makes little sense.

An equally important factor was the failure to recognize that financial innovation was not the same as non-financial innovation. The latter raised problems which Schumpeter described as those of "creative destruction," as old technologies and products had to be eased out, whereas the former had a potential downside with huge adverse effects so that we were dealing with what I have called the problem of "destructive creation." This required a comprehension of the downside of the new instruments, along with vigilance and monitoring which were absent.

But this governmental regulatory error was also compounded by the contributions made by the U.S. Congress. Congress aided the formation of the housing bubble through low-quality mortgages from Freddie Mac and Fannie Mae. Congress also fueled, instead of halted, the race to the bottom, such as when Senator Charles Schumer (D-NY) sided with the big investment banks when they successfully lobbied the Securities and Exchange Commission for absence of capital and reserve requirements.

The proposed reforms are many-sided. Capital and reserve requirements will be introduced for investment banking activity. The "destructive creation" point and the consequences of the Wall Street-Treasury Complex have been grasped and should inform the new regulators. Some key international coordination has been achieved. I do not agree with many details, but the policy leaders deserve an A to date.



*A gentleman's C.*

**MARSHALL I. GOLDMAN**

*Senior Scholar, Davis Center for Russian and Eurasian Studies, Harvard University*

Most commentary on the great financial crisis of 2010 analyzes it clinically from a macro perspective. As a director of a reasonably small community bank with headquarters in a Boston suburb, I have also had the unique opportunity to observe the financial crisis from the inside or bottom up.

Our bank started forty years ago with one office operating out of a trailer. We have survived a variety of financial ups and downs and today have more than \$2 billion in assets and a dozen branches, almost all created from scratch.

In other words, while we are not one of the largest—sometimes stodgy—traditional Boston banks, we are nonetheless now a solid institution. That means we have survived several financial recessions and are treated as one of the better-managed community banks in New England. We have also watched other banks that opened their doors at the same time we did disappear either through merger or financial imprudence.

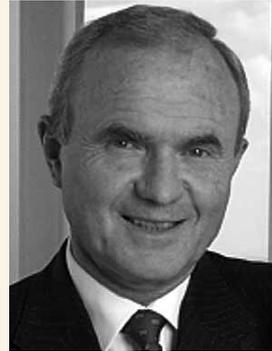
We are used to hearing banking consultants tell us that we have entered a new age where recessions are a thing of the past and that if we want to survive we must take more risks. But we balance such advice with the realization that financial recessions are not unique events and that hard as the country's banking authorities might try, recessions are likely to reoccur.

If anything, when we hear such advice, we worry that it might be time to be more cautious than usual since such thinking has traditionally led to incautious lending.

We directors don't always agree about this and on occasion the bank has lost business and passed up unique opportunities. But it helps that the bank is still essentially a family bank and that the chairman of the board and CEO are its largest stockholders. As a result, they feel it is their money that is at risk. Perhaps more than anything, the dominance today of mega-banks and the pushing aside of owner-directors in other banks has brought with it an end to more cautious bank management. That can seem like an important advantage at the beginning of a business cycle

but a nightmare as exuberance is transformed into regret and a search for scapegoats.

I would give our banking authorities a grade C and I would be amazed if they manage to prevent other recessions and bank failures in the future.



*The real test comes in how they reduce budget deficits. The jury is still out.*

**OTMAR ISSING**

*Former Chief Economist, European Central Bank*

Additional expenditure to stop the crisis from developing into a depression was appropriate. However, these decisions were the easier part. The real test comes with the need to reduce budget deficits, to set priorities for public spending, to agree on reasonable rules for the financial industry, and resist the temptation of over-regulation. Here the jury is still out.



*On avoiding a second depression, an A. On fixing the causes, a gentleman's C.*

**GARY CLYDE HUFBAUER**

*Reginald Jones Senior Fellow, Peterson Institute for International Economics*

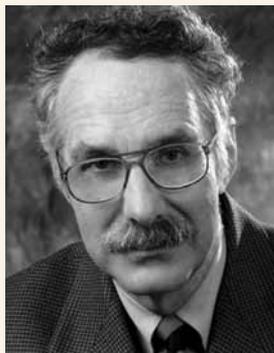
In 1939, after a decade of Depression with a capital "D," gross federal debt reached 54 percent of GDP. That left ample financial room to fight the Second World War, which raised federal debt to 122 percent of GDP.

This time around, thanks to resolute action by Team Obama and Chairman Bernanke, the United States avoided a Second Great Depression. For this, they deserve an A. But

gross federal debt will almost reach 100 percent of GDP in 2011, on top of unfunded liabilities that amount to another 300 percent of GDP. In other words, the United States comes out of the Great Crisis with little financial capacity to meet the next global shock. Nor is there any prospect of agreement between Liberal Democrats and Tea Party Republicans on sensible spending cuts and tax increases. Where is Alexander Hamilton when we need him?

Scoring and fixing the causes of the Great Crisis are important tasks. Team Obama and Chairman Bernanke may eventually earn a gentleman's C for correcting past failures. They are making progress on financial regulation. Still, among other question marks, we don't know what the Administration will do with Fannie and Freddie, nor whether the Fed will gently deflate the next asset bubble.

But the next financial crisis seems far more likely to arise from yawning public debt and deadlocked politics than from a repetition of prolonged easy money, sleepy regulators, Fannie and Freddie on steroids, and Wall Street follies. For the coming crisis, the most Team Obama has done so far is appoint a commission.



*Policymakers must recognize there is a deeper source of economic stability.*

**ROBERT SAMUELSON**

*Columnist, Newsweek and the Washington Post, and author, The Great Inflation and Its Aftermath: The Past and Future of American Affluence (Random House, 2010)*

One ritual of every crisis is the hangover: the search for villains, the pursuit of "reform," the pledges that it "will never happen again." We're deep into that process, and the resulting narrative conceals as much as it reveals. Blame is heaped upon loose monetary policy, sleazy mortgage brokers, greedy investment bankers—and the Chinese, because their reinvestment of huge trade surpluses suppressed U.S. interest rates. All true, up to a point. But the standard story omits the larger context in which these mistakes occurred and the lasting lesson that they suggest.

The lesson is simple: we have not, as was once supposed, moved beyond the booms and busts of the nineteenth century. Prosperity was the ultimate source of the crisis. The prosperity originated in the benefits of the defeat

of double-digit inflation in the early 1980s. As inflation fell, interest rates dropped and asset prices (stocks, bonds, homes) rose. The resulting wealth produced a consumption boom. Low inflation promoted economic stability. From 1982 to 2007, there were only two mild recessions. Unfortunately, the resulting over-optimism bred complacency and carelessness among bankers, borrowers, regulators, and economists that culminated in crisis.

Some "reforms" may protect us against dangers, but the basic source of economic instability goes deeper. As I write in *The Great Inflation and Its Aftermath* (paperback edition): "Modern, advanced democracies are dedicated in part to delivering as much prosperity to as many people as possible for as long as possible.... The innate human tendency to overdo things suggests that the very striving for a perpetual, ever-improving prosperity creates its own undoing."



*An Incomplete.*

**RICHARD N. COOPER**

*Maurits C. Boas Professor of International Economics, Harvard University*

The Obama Administration clearly should be given an "Incomplete" on the issue of financial regulation. At the time of writing, twenty months after the peak of the crisis, two competing bills sit in the Senate, neither passed, and another in the House that is quite different in crucial details from both of them. All bills touch the relevant bases, but differ in important detail. And all have neglected the potential of new legislation to tidy up and clarify the diverse government agencies that now have a role in financial regulation and supervision. All implicitly take the position that financial regulation is a matter for the United States alone, largely neglecting the fact that in a globalized financial market other financial centers compete with the United States for some services, and that therefore financial regulation needs to be coordinated across these countries. Little attention has been given to accounting rules, which are keyed to revealing the position of individual firms on the assumption the system as a whole is functioning well. Thus, they are highly

pro-cyclical, and contributed both to the unsustainable boom and to the subsequent unnecessarily deep bust. The advice of lawyers without regard to financial integrity has also received too little attention.

In short, there is under-reach in rationalizing the institutional framework for financial regulation and supervision, and in oversight of a private accounting standards-setting body that has strong influence on whether or not firms are “solvent.” And perhaps there is over-reach in limiting the future development and even writing of “derivatives,” a term that like “services” is now too broad to be useful as a collective noun.



*The fairest grade:  
an Incomplete.*

**MICHAEL J. BOSKIN**

*T.M. Friedman Professor of Economics and Hoover Institution Senior Fellow, Stanford University, and former Chair, President's Council of Economic Advisors*

The immense global policy response helped prevent an even worse recession, though not a second Great Depression—that’s economically illiterate media hyperbole. A full, useful evaluation must compare the net short-term benefits both with the immense long-run costs and with any alternative policies that could have done better at lower cost, such as a partial payroll tax holiday instead of the costly, ineffective U.S. stimulus bill. The fairest grade for global policymakers’ response to the financial and economic crisis is thus an Incomplete. Some policies deserve high marks, others low marks. Some policymakers (for example, U.S. presidents and Treasury secretaries) have changed, and some earlier helped cause or worsen the crisis. So far, monetary policy—originally a prime cause of the problems—and the automatic fiscal stabilizers, most notably in the United States, head the class. Wearing the dunce cap is discretionary fiscal responses such as that of the United States, a tragic wasted opportunity diverted to social engineering and pork.

The reasons for the Incomplete grade are fivefold. First, some policies are still unfolding, such as financial reform and fiscal and monetary exit strategies. Second, the full effects of policy response on the strength of the recovery are still to be determined, though so far they are much

weaker than recoveries from previous deep recessions. Third, the large long-run costs of the policies are substantial, including severe rupturing of public finances, inefficiencies from social engineering, pork, and industrial policy subsidies, increased moral hazard from bailouts, and likely future political pressure for overly aggressive monetary and fiscal responses to minor problems. Fourth is the risk of eventual serious inflation if central banks do not withdraw their immense liquidity infusions in time, a subtle maneuver that has beguiled them in the past, or are pressured into monetizing exploding public debt. And last, there is the risk of permanent expansion of government causing a large drag on long-term economic growth.

As to root causes, the responses rarely come close. Toxic assets remain unresolved. Financial reform includes some unfortunately necessary items, but would better have begun with enhanced bankruptcy and debt-to-equity conversion. And any reform totally ignores Fannie Mae and Freddie Mac, now sitting with limitless credit lines and no path to resolution. Repeating the mistake of loose money (negative real interest rates in a booming economy in 2003–05) appears no less likely. Global imbalances are rebuilding. The largest systemic risk is now out-of-control public debt and thus the prospect of large tax hikes and/or inflation. President Obama’s budget, for example, calls for—but doesn’t come remotely close to achieving—stabilizing the debt-GDP ratio at almost double the pre-recession level, removing fiscal flexibility in the next downturn, while risking a future financial crisis.



*An initial B, which  
could turn into an F.*

**JIM O'NEILL**

*Head of Global Economic Research,  
Goldman Sachs International*

I think there were many possible causes of the crisis, some closely intertwined. But at the core, there were three. One was the global imbalances, and the desire and need for the United States to attract foreign savings to supplement its domestic shortfall. By definition—not that many commentators seem to realize this even now—the United States would keep finding ways to attract foreign

investment even if nominal returns declined. On some level, the foreign investment in asset-backed securities, whose quality turned out to be much lower than their credit ratings, was effectively inevitable. And moreover, perhaps it was the final way that intermediaries could design a way to attract more, before the whole game had to change.

The second cause, not unique to the United States but perhaps most widely embraced, was the notion that everyone, almost irrelevant of current or prospective income, should be able to own his or her home. In a democracy as proud as the United States, once this theme has acquired such a powerful force, it is tough for anyone to turn off the tap, including independent policymakers and regulators.

As for the third, despite protestations, the Fed appears to have implicitly complied with having an easier monetary policy that allowed the financing schemes to be easily undertaken.

In terms of addressing the causes, the most optimistic outlook is that global imbalances are clearly turning. China is now pursuing a domestic path of economic development, and the U.S. need for foreign saving has dropped. As for the other issues, here is the current and future dilemma. Rather than truly recognize the fact that virtually everyone played a role, and the real culprit was low domestic savings and false aspirations, we have entered a world of “shifting the blame” in which political figures are abstaining from any policy responsibility and putting all the blame at the doorstep of the banks. The same is widely true in Europe. I had believed that the advent of the G20 was an excellent development, and with it, the likely path of much justified counter-cyclical use of capital to be imposed on banks through future cycles, as agreed by the Financial Stability Forum. But we are seeing more evidence of how, as each month of 2010 passes, policy prescriptions are increasingly domestically driven and motivated by election timetables. My initial grade of B for the 2009 policy response is in danger of passing into serious failure territory.

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**GEOFFREY LITTLER**

*Former Second Permanent Secretary of the Treasury,  
United Kingdom*

***A D, but with a strong  
flavor of an F.***

**I**t seems to me that this crisis has demonstrated, especially for the United States and United Kingdom, that self-regulation is never likely to be an adequate basis of control, with fundamental conflicts of interest standing in the way; and that the policymakers and supervisors of both countries

have a poor record, whether in tackling major problems of the design and management of policies, or indeed to notice in some relatively straightforward areas such as monitoring mortgage lending, the damage done by the availability of Fed backing for mortgages in the United States, and continued urging in the United Kingdom of mortgages of 130 percent of values, in both cases until a late stage. In the United Kingdom for as much as two years the prospect of a critical general election has caused unwillingness even to discuss any potentially “unpopular” measures and to focus on the need for coherent structure of co-operating policy-makers and supervisors. My overall grading cannot be better than D, and with a strong flavor of F.

My earnest hope is after the U.K. general election, minds will have to focus in the United Kingdom, while in the European Community the problems of Greece and others must point up the need for better cooperation between leading financial centers. I would hope to see high priority given both nationally and internationally to discussing some concepts such as the need for a single national body for each major financial center, recognizing the dangers of “divide and rule,” and the need for adequate staffing of such a body (there could well be a few able investment bankers who could be interested in a gamekeeper role). It would be a mistake to allow discussion of these needs to be dominated by political concerns; this is a highly developed specialist area and it will need to be cultivated with care.



***An F!***

**PETER J. WALLISON**

*Arthur F. Burns Fellow in Financial Policy Studies,  
American Enterprise Institute*

**T**he housing policy of the United States caused the financial crisis in the United States and across the globe. Before the crisis, there were 27 million subprime and other high-risk loans—about half of all mortgages—in the United States. This was a completely unprecedented number. When these mortgages began to default in early 2007, they caused the collapse of the mortgage-backed securities market. With no market price for trillions of dollars in mortgage-backed securities, financial

institutions had to write down the value of their assets. Virtually all were affected at same time, because virtually all held the same weak mortgage-backed securities. Investors did not know where the worst losses lay, and a panic ensued, only temporarily allayed by the rescue of Bear Stearns. When the U.S. government failed to rescue Lehman Brothers, the panic accelerated.

There is no need for a more complex story. When the largest class of assets in a financial system loses virtually all its value within a few weeks, no financial system can escape serious damage.

Why were there so many subprime and other weak loans? Because the U.S. government was either the buyer itself or required that they be made. As the crisis began, twelve million of these loans were held or guaranteed by Fannie Mae and Freddie Mac, five million guaranteed by the Federal Housing Administration, and two million were held by four large commercial banks to win approvals of the Fed for mergers. That's nineteen million, over two-thirds of all the weak mortgages—and these failed at unprecedented rates when the U.S. housing bubble finally deflated.

The Obama administration's legislation, now working its way through Congress, is based on the false notion that the crisis was caused by deregulation, and does nothing to address the real cause. It gets an F.



*An unambiguous A.*

**SURJIT S. BHALLA**  
*Chairman, Oxus Investments*

**A**round the globe, and even in Europe, growth is good, and in many instances, far ahead of expectations. Given that the Great Recession ended less than a year ago, and lasted only a year, kudos belong to those who helped bring about this change in climate. So the immediate reaction to the question of grading the policymakers has to be an unambiguous A; on reflection, the answer remains the same but is arrived at after making some assumptions.

We have been asked to offer a grade on how effectively the policymakers have dealt with the root causes of the financial crisis. It is good that economic growth is back,

but the joy might be shortlived if the cause is not dealt with. So what was the cause for the Great Recession? Unfortunately, there are almost as many causes as there are economists, or policymakers, or hedge fund managers.

I believe that an important cause was, take your pick, global imbalances caused by the thirst for “glut” savings in China, or the never-ending desire of the Americans to consume until savings do them part. On closer inspection, this is really one cause, and on a still closer look, the determinant most likely is the deeply undervalued level of the Chinese currency, the yuan. (See “Devaluing Prosperity: Mis-Aligned Currencies and Their Growth Consequences,” Peterson Institute, forthcoming.) Once the yuan begins its inevitable, and inevitably desirable, glide upward, one would begin to conclude that the authorities have done an A-level job.

The post-2008 world is different: There seems to be coordination among global policymakers. Roles have changed with the need for coordinated policies. For example, the International Monetary Fund radically suggested that the world run high fiscal deficits to get out of the deep hole. If this shock were not enough, the IMF risked several eggs on its face by continuing on for far too long that the world was mired in a never-ending and deeper slump. Question: did they make the forecast believing it to be true, or did they do so in order to ensure the world recovery?

Whether it be the need for government deficits to be expansionary in 2009, or for China to revalue in 2010, the chorus is near-unanimous. So the likelihood of convergence in policies and goals is high; my prediction is that the world will see an unparalleled bit of coordination over the next few years. If this prediction comes true, the policymakers deserve an A; if not, then I am being naïve and overly optimistic.



*Grade: C-minus.*

**SUSAN ARIEL AARONSON**  
*Research Associate Scholar and 2009–2010 Policy Research Scholar, Elliott School of International Affairs, George Washington University*

**G**20 policymakers deserve a grade of C-minus for their efforts to stabilize the global economy. By keeping capital cheap, these officials greased global

markets. This strategy allowed banks to quickly recover and resume lending, but it also penalized savers. Policymakers kept too myopic a focus on the supply and demand of money, hence I give them a relatively mediocre grade.

My grade is also colored by the failure of the G20 to think long-term about other kinds of markets. The world has a surplus of capacity in sectors from automobiles to steel, computers, toys, and semiconductors. Perhaps business leaders presume that a rising middle class will absorb this capacity in the future, but until then, the oversupply of goods hangs over the global market, causing downward pressure on prices. Policymakers are unwilling to address this global overcapacity because they fear increasing job loss in a time of high unemployment. However, by their failure to act, G20 policymakers have highlighted a different problem of overcapacity. The International Labor Office estimates that three billion of the world's 6.7 billion people are in the workforce. The world has an abundance of workers skilled in a wide range of fields from anthropology to radiology to welding. The ILO also reports that 7–10 percent of those that want to work can't find jobs. At the national level, this number ranges from 4–40 percent. Thus, there is a global jobs crisis, but policymakers devise job policies at the national and not the international level. How one country works to create or maintain jobs can have implications for the terms of trade, economic growth, and political conditions in others. We must find ways to collaborate to create jobs, or our struggle to maintain jobs at the national level may shrink workers' wages, global demand, and ultimately global economic growth.



*An A.*

**RUDOLPH G. PENNER**

*Institute Fellow, Urban Institute, and former Director, Congressional Budget Office*

**W**e are condemned to experience financial booms and busts unless we figure out a way to outlaw greed. Having said that, the regulatory proposals now stumbling through Congress include some good and some bad ideas. It seems a good idea to push derivative trad-

ing into clearing houses and exchanges. It seems a bad idea to impose stringent conditions on angel investors. There may be no good way to deal with "too big to fail." Do we really want to have limits on size that punish success?

It is useful to give the U.S. Treasury clearer authority to take over failing firms. They can then be sure that creditors and owners really suffer. However, in the recent crisis, firms that were not clearly failing were asked to accept assistance as a means of restoring confidence. I am not sure that was a bad thing to do.

It is a really bad idea to put the consumer finance protection agency in the Federal Reserve. First, the Fed faces a big enough challenge running monetary policy and they should concentrate on that task. Second, it would be especially dangerous to finance the agency from the Fed budget. The taxpayers will still pay for it, but the cost will be much less transparent than if it were in the regular federal budget and financed with annual appropriations. One worries that this could be a precedent for the Fed financing all sorts of public activities.

Last, Fannie and Freddie badly need a death panel. Too bad they are not being considered in this effort.

As this is written, legislation is far from complete, so the U.S. Congress can only be given an Incomplete. If they get rid of the bad ideas and keep the good ones, I'll give them an A.



*Central bankers allowed Asia's excess savings to create surplus liquidity. They could have sterilized those flows.*

**MILTON EZRATI**

*Senior Economist and Market Strategist, Lord, Abbett & Co.*

I always feel uneasy when asked to grade policymakers. It seems unfair and not a little ignoble to second-guess those who must act in the moment with limited information and in the face of great uncertainty. Still, people must judge the performance of those responsible, however fundamentally difficult—indeed, impossible—their job is. This crisis seems to require two such judgments, one on how policymakers reacted once the mess came to light and another on how they controlled matters prior to the implosion.

On the first of these, they probably deserve a reasonably satisfactory grade. Markets, after all, were on the mend by early spring 2009. The world's central bankers deserve most of the credit. They moved quickly to provide needed liquidity. Their coordinated response also surely stemmed panic by reassuring markets that they would use their immense, joint resources. Had other officials acted with the same purposeful calm, the panic probably would have subsided sooner. Instead, *ad hoc* arrangements made amidst desperate weekend negotiations created a sense that matters were out of control, which, even though true, did not need a spotlight. Greater calm might have emerged sooner had regulators also relied less on sudden inventions and more on conventional means to resolve corporate troubles, including bankruptcies. Especially counterproductive in the context was the sad spectacle of two presidents, first Bush and then Obama, telling the world that the American economy was on the brink of disaster.

On the second grade, the central bankers score less well. They allowed Asia's excess savings to create a surplus liquidity in American and other financial markets. They could have sterilized those flows, and now, in retrospect, it is clear that it should have done so. Comments from Alan Greenspan, Ben Bernanke, and several European central bankers indicated that they were aware of the flow and even had an idea of its ultimate effect. Yet, they failed to take any counterbalancing action. There was plenty of warning, too. In the 1990s, the liquidity flow, looping through developed financial markets, created the Asian bubble and 1997 implosion. That same flow contributed to the internet bubble that burst at the turn of the century. By this third round, central bankers might have served better had they responded before the disaster.



*They deserve a B, which could drop to an F.*

**JOHN DESPRES**  
*Global Investor and Economist*

**G**lobal leaders deserve a B, that is, neither a valedictorian's A nor a gentleman's C, for what they've done so far to prevent the possibility of a second financial crisis in the next decade.

An A is out of the question because global leaders have not begun nor even planned to break up or shrink the unstable, crisis-prone global financial behemoths that are too-big-to-bail, not just to fail. Nor have adequate disclosure and capital requirements been imposed on their systemically risky businesses. Indeed, their vast scale and sheer complexity entail inevitable hazards for the global economy. Moreover, those gargantuan banking conglomerates are managed by fallible leaders whose abilities to foresee shocks to the global financial system and abrupt shifts in credit market spreads are unlikely to be better in the future than they have been in the past.

So, until plans to dismantle, downsize, and control them are agreed and implemented, another great financial crisis, as bad as or worse than the last, remains a live possibility. Still, global leaders deserve more than a C, which just means they did no harm, because they have renewed long-stalled efforts to broaden and strengthen international banking regulations.

But unless global leaders adopt binding new controls to arrest and reverse the growing concentration of profit-seeking money and power before the next big bubble blows up, their mid-term B would be eclipsed by a final grade of F.



*It takes two to tango. Yet the United States and China remain flat-footed.*

**JEFF FAUX**  
*Distinguished Fellow, Economic Policy Institute, and author, The Global Class War (Wiley, 2006)*

**G**lobal imbalance and deregulated U.S. finance were the tap roots of this crisis. Correcting the global imbalance will take at least two—the United States and China—to tango. Both remain flat-footed. The United States has to save and export more; China must increase spending and imports. With two-and-a-half trillion dollars in the bank, China can afford to wait for a serious offer, that is, a combination of political concessions and a credible threat to constrict access to the U.S. market. But Obama's advisers are mostly Wall Street guys; a strong dollar means cheap foreign assets. So they can't even bring themselves to say what the whole world knows is true—China manipulates its currency to keep its trade surplus high.

At home, the dribble of financial reform that is being squeezed out of a dysfunctional Senate is inadequate. “Too Big to Fail” is enshrined; protections against predatory lending are flimsy, and the door remains ajar for creation of over-leveraged debt obligations. More transparency for shadow bank securities is welcome, but we now know that much of the recklessness was done with eyes wide open.

The need is not just to reform the financial sector; it is to shrink it. The role of bankers and brokers should be limited to providing credit to the nonfinancial industries for production, rather than trapping it in their own casinos. A hefty securities transaction tax would be a good start. But this seems beyond the policy class imagination. So the green shoots of the nascent recovery have the same DNA as the last one.

Unfortunately, the global reservoir of confidence in U.S. Treasuries that saved us from Depression hell is now much lower. With no substitute for the dollar on the horizon, it could be the fire next time.



### *An Incomplete.*

#### **SUSAN M. PHILLIPS**

*Dean and Professor of Finance, George Washington University School of Business, and former member, Board of Governors of the Federal Reserve*

**P**olicymakers to date deserve an “Incomplete” for the job they have done in addressing the root causes of the financial crisis. While a number of regulatory and supervisory initiatives have been undertaken to deal with parts of the crisis, those actions are limited due to the fragmented nature of the U.S. financial regulatory structure and the need for legislative action. I can only give those regulatory piecemeal fixes a grade of B—they are partial, late, and were developed only after disruptive stops and starts. But even more important, we have yet to see the final financial reform legislation and the Fed’s unwinding of its extraordinarily supportive monetary policy and the expansion of its balance sheet.

Only when all the pieces of financial regulatory reform are in place and the economy has returned to a sustainable growth rate with a more robust employment situation can

we assess whether policymakers did in fact address the root causes of the crisis. As best I can tell from the proposals still on the table, the answer may not be affirmative. First, the shrinking of the Fed’s balance sheet could cause new unanticipated capital market disruptions. Second, the reforms currently being considered do not appear to address the political issues related to Fannie Mae or Freddie Mac. Third, resolution of the “too big to fail” issue seems to be elusive. Fourth, treatment and valuation of over-the-counter derivatives seems far from settled, including transparency, trading and clearing venues, and even regulatory oversight.

And finally, monetary and fiscal policies will always face challenges where such emotional or intransigent issues as home ownership, national savings propensities, credit policies, leverage, and asset bubbles are concerned. Policymakers may recognize these problems, but their solution can be unpopular, limiting policymakers’ ability to act counter-cyclically. More often than not, however, bubbles and changes in the risk environment are not easily discernable. Good micro setting credit risks can turn sour when macro conditions change the stage for another financial crisis. So, even if the Fed unwinding proceeds flawlessly and legislation is enacted, not all the risks for future crises are likely to be rooted out.



### *A C effort.*

#### **ANNE O. KRUEGER**

*Professor of International Economics, School of Advanced International Studies, Johns Hopkins University, Senior Fellow, Stanford Center for International Development, and former First Deputy Managing Director, International Monetary Fund*

**I**’d give the effort a C. All the factors mentioned—global savings imbalances, lack of transparency, regulators and credit rating agencies asleep at the switch, banks’ inability to value the sophisticated assets on their balance sheets, overly accommodative monetary policy—made the downturn more severe than it might have been. Some of them have been addressed (initial liquidity, fiscal stimulus, and so forth). And the bill to overhaul financial regulation is still a work in progress, so it is too soon to say.

But some issues have not been addressed. First and foremost, the international community has no mechanism or agreed-upon procedures to induce both surplus and deficit countries to reduce their side of global imbalances. There is certainly a prospect that unsustainable current account deficits and surpluses could reemerge, despite the G20's determination to use "peer pressure" to achieve adjustment.

The second issue is "too big to fail," and that is difficult to address, but more can and should be done: a graduated tax, subordinated debt, and other measures could be helpful. But these would, of course, require international coordination so that countries adopting measures do not penalize their own banks relative to those in other countries.

Third, although the G20 responded to the challenges of the Great Recession, the International Monetary Fund still does not have a clear mandate to lead in all cases, as the difficulties with Greece and the euro area show. Delays in addressing crises are costly, and an agreed-upon mechanism to achieve quick action is needed for the international community as a whole.



*An F!*

**BERNARD CONNOLLY**

*Managing Director, Connolly Global Macro Advisers*

**P**olicymakers get an F. It is a straightforward prediction of economics that intertemporal disequilibrium creates bubbles and macro Ponzi games—and thus financial crises.

In the United States, the Fed's dual employment/inflation mandate failed to keep real long rates of interest in line with a surge in the anticipated rate of return on investment in the mid-1990s. The stock market bubble of the late 1990s and a U.S. current-account Ponzi game were unavoidable consequences. Thereafter, to prevent or mitigate recession, the Fed had to produce ever-lower levels of real long rates and/or risk premiums, worsening the intertemporal disequilibrium and increasing risk when risk premiums were declining. No doubt many banks behaved foolishly or even reprehensibly. But they were responding faithfully to the incentives from perverse policy signals. Different financial-sector behavior or tighter regulation

would just have changed the channels through which the bubble and the Ponzi game grew: It could not have prevented them—or financial crisis.

A capitalist economy cannot work if real rates of interest and of return are way out of line with subjective time preference. There are now two feasible choices: pursue free-market, pro-capitalist policies to increase the rate of return and allow real rates/risk premiums to "normalize" without producing a depression; or go to socialism. Unfortunately, policymakers have made another financial crisis virtually inevitable by punitive political scapegoating rather than seeking to understand or admit why the highly predictable 2007–09 crisis happened, and it is not hard to guess which of the two routes will be followed, willy-nilly.

In Europe, the lunacy of monetary union pre-programmed a series of financial crises by creating the most egregious credit bubble of them all—again by ensuring that real interest rates were forced out of line with anticipated rates of return in several countries, and by converting currency risk to credit risk, yet pretending that credit risk no longer existed. The crises in the euro area are only just beginning. Worse is yet to come, and politicians will respond by taking control of more and more aspects of the economy. Perhaps that was what monetary union was always intended to do.



*Policymakers have not yet addressed the root causes.*

**DIANA CHOYLEVA**

*Director, Lombard Street Research, and co-author, The Bill From the China Shop (Profile Books, 2006)*

**T**he structurally engrained desire to save excessively in the second, third, and fourth largest economies in the world was at the root of the Great Financial Crisis. If America had not stepped up to the challenge to borrow and spend, the global economy would have been depressed. From its recession low in the third quarter of 2001 to the end of 2007, U.S. real output growth averaged a trend 2.75 percent, while consumer price inflation was 2.75 percent. But the Eurasian savings glut meant this reasonable result within the remit of monetary policy was only achievable with rapidly rising debt ratios. As

the ability to rack up debt in the private sector in the United States and the other borrower economies got exhausted, risk was re-priced and the global financial and economic turmoil ensued, exposing major regulatory oversight flaws, myopic policy behavior, and an overblown financial sector.

Two-and-a-half years into the work-out, the global financial imbalances are still in place as the saver economies have not addressed their structural deficiency of genuine domestic demand. The Eurasian savings glut has turned into a global private sector savings glut to the tune of U.S. \$3.2 trillion. The knee-jerk policy response was to restore liquidity and maintain the status quo, shifting the excess borrowing to the last remaining sector—the government. Since then, policy efforts have been focused on dealing with some of the shortcomings in regulation and the structure of the banking system. But so far, policymakers have not addressed the root cause of the financial and economic crisis. The saver economies—China, Japan, and Germany—show very little understanding of their key role, even though they are the ones to bear the brunt of the prolonged painful adjustment that is in store for the global economy.



*They deserve a D.*

**CLAYTON YEUTTER**

*Senior Advisor, Hogan Lovells, LLP, and former U.S. Trade Representative, U.S. Secretary of Agriculture, and CEO, Chicago Mercantile Exchange*

This was not your usual recession! Traditional cyclical factors were at the scene: savings and investment imbalances exacerbated by blatant currency intervention. That trigger was cocked, but it didn't fire. And it might still be cocked today but for all the foolishness that occurred elsewhere.

What triggered this recession was a combination of ill-conceived policies and abominable conduct in the financial services industry—where the word “service” is now a misnomer. The Congress essentially mandated loans to anyone who wanted to own a home, whether or not they could afford it. When a policy is doomed to fail unless prices stay on an upward trajectory, it'll probably fail. And it did.

For the financial industry, all those home loans created an irresistible opportunity to make huge profits. They packaged them as “low-risk” investments, securitized them, persuaded credit agencies to bless them, leveraged them through other exotic instruments, and then marketed them aggressively to people and institutions who did not understand what they were buying. It was a great business plan while it lasted.

There wasn't much transparency in all this, but no one paid much attention. There was a lot of counterparty risk, and the enormous leverage that prevailed meant that huge gains and losses were inevitable. No one paid attention to that either. Finally, it exploded—and millions of Americans who had nothing whatsoever to do with this are picking up the tab.

The industry contends it did nothing wrong, that this was just “business as usual.” Their attitude is buyer beware, and “Don't complain if we were smarter than you were!” But that rings hollow when vast numbers of innocent people are hurt.

Regulators have constituencies to which they are accountable and responsible. But most financial industry regulators sat on their hands as this harmful scenario unfolded. They get a D at best for their performance, and the same applies to both the executive branch and Congress.

The good news is that we're a resilient people. We'll fix this going forward, with greater transparency, more “clearing house” protections, awakened regulatory entities, and a duly chastened legislative branch.



*An F.*

**MURRAY WEIDENBAUM**

*Mallinckrodt Distinguished University Professor, Washington University in St. Louis, and former Chairman, Council of Economic Advisers*

Policymakers are still dealing with the lingering effects of past mistakes in financial markets and looking for a villain to blame. The sad truth is that every group participating in the housing finance process—from Main Street to Wall Street (and Washington)—contributed to the situation.

Greedy homeowners did not provide honest listings of income and assets. Opportunistic mortgage brokers passed on the mortgage applications to lazy financial institutions that failed to review the inadequate applications before passing the mortgages on to the modern alchemists. They, in turn, packaged those vulnerable mortgages into esoteric securities which rating agencies blessed with undeservedly high ratings.

Let us not forget the Federal Reserve that lubricated the entire process by keeping interest rates low for too long. Also, the U.S. Department of Housing and Urban Development and congressional leaders pushed Fannie Mae and Freddie Mac into lowering their lending standards. Simultaneously, amateur economic historians assured the public that national housing prices never decline.

Sadly, it is likely that, with the passage of time, people will forget these sordid details and the economy will be vulnerable to another large-scale financial mess. U.S. policymakers are still playing the popular Washington parlor game of responding to serious problems by shuffling boxes on the federal organization chart. Legislative and executive branch leaders should acknowledge their roles as villains, not victims. Neither Wall Street nor Main Street created Fannie and Freddie. Congress did.

Sensible laws and regulations should require financial companies to take responsibility for their actions, notably performing due diligence before passing on mortgages and derivatives to unsuspecting investors. Sensible boundaries should be set on the ability of commercial banks to take on huge investment risks. Until policymakers face these issues, they deserve an F!



*They deserve a D.*

**STEFAN SCHÖNBERG**

*Former Deputy Director of International Relations,  
Deutsche Bundesbank*

**P**olicymakers have been definitely more successful in their efforts directed at crisis management than at preventing future crises. There is still no clear understanding of the causes of the crisis and, hence, of the priorities to be set for reforms.

Targeting national savings/investment divergences, a favorable phenomenon of a globalized world economy, would be counter-productive. Capital flows not distorted by exchange rate manipulation, capital controls, trade protectionism, or imprudent fiscal behavior add significantly to global welfare. Therefore, financial regulation must ensure that such flows can be safely absorbed and the ensuing benefits be reaped.

Likewise, attributing the crisis to the monetary policies of major central banks not being more restrictive than needed for keeping inflation low would overtax central bankers. Apart from the impossibility of determining appropriate ranges for asset prices, I haven't come across a convincing explanation of how central banks could credibly pursue two potentially strongly conflicting objectives with one instrument. That is why central bankers have remained remarkably passive lately, in spite of their own warnings of renewed asset bubbles building up.

Stronger regulation of financial products and market participants, in particular establishing more transparency in the asset-backed securities and derivatives markets and putting a stronger lid on banks' financial leverage and risk-taking, constitutes the most urgent need for reforms. European policymakers, however, missed the opportunity for early corrective action, believing for too long that the subprime crisis was exclusively an American event. Subsequently, they initiated a series of populist side-shows, hitting out, indiscriminately, at bankers' bonuses, rating agencies, private equity, hedge funds, and tax havens—all issues which were not at the core of the crisis.

Only lately have European regulators and supervisors come around, establishing—together with their G20 counterparts—more appropriate priorities for reforms. Now the problem has shifted to implementation. Fear of a credit squeeze fostered by an undercapitalized European banking system, disagreement over national versus European supervisory competencies, and efforts of preserving outdated financial structures and competitive advantages in specific market segments raise the specter of patchwork reforms inviting to regulatory arbitrage.

I'd give policymakers a D. ◆