Global Financial Crisis: Lessons for the Future

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On the panel, I will focus on future implications from issues discussed at the "The Global Financial Crisis in Retrospect" conference. Naturally, a view of the future is speculative. However, we can develop potentially productive pathways for crisis prevention based on informed speculation, papers presented, and experience.

Since the collapse the fall of Lehman Brothers and crisis in Iceland, a succession of "never befores" has overwhelmingly influenced financial markets movements. Specifically, three "never befores" will constrain policy decisions and drive our economic and financial future.[1]

For instance, "never before" has there been such:

- Large scale intervention by central banks and governments,
- Growth in the financial regulator apparatus and labyrinth of rules governing markets,
- Distortions across a wide range of financial markets.

Central Banks and Governments: In the U.S., never before has such a monetary experiment been conducted. In the last six and one-half years, the Fed's high powered money or monetary base expanded by nearly 400%. This is the largest cumulative six and one-half year expansion since the founding of the Fed in 1913. The second largest six and one-half year cumulative expansion ended in 1944 – helping the US exit the Great Depression and navigate a World War. It was only half the size of the present day monetary injection, with a 200% increase over the same period.

Despite successive Fed tightening, real interest rates remain negative. The European Central Bank, Bank of Japan, and Riksbank maintain very easy monetary stances. The Reserve Bank of Australia and Bank of Canada stances are also somewhat accommodative.

The global monetary ease since the Lehman and Icelandic crises dramatically raises the risk of another financial crisis or at least a meaningful correction.

[1] Lawrence Goodman, "The Unwind: What's Next for Global Markets," Remarks at the Capital Markets Credit Analysts Society: Twenty-Sixth Annual Dinner Meeting, May 27, 2015 - http://www.centerforfinancialstability.org/speeches/unwind_052715.pdf.

Regulations and Rules Regulating Markets: Rapid development of the financial regulator apparatus and labyrinth of rules governing markets represents a major structural shift. In remarks prepared for the "Bretton Woods: The Founders and the Future" conference, CFS Advisory Board member and inventor of financial futures and carbon trading, Richard Sandor noted that "at over 2,300 pages Dodd-Frank is longer than the Old Testament, New Testament, and the Koran combined."[2] So, yes, there has been a massive structural shift in the regulatory apparatus.

Richard's bogey for successful financial policy is for officials to achieve the same or better regulation without increasing transaction costs. It is unclear whether we have achieved this objective.

Regulatory changes have unequivocally impacted the functioning of markets and the economy. For instance, since Dodd-Frank, there has been a collapse in available market liquidity despite the more than ample central bank liquidity. For instance, broker dealers are warehousing less risk. This creates "jump risk" in market prices or the potential to exacerbate downward spirals in prices in the likely event of a meaningful correction ahead.

Distortions across a wide range of financial markets: Distortions exist across a wide range of financial markets. They pose challenges for investors and officials alike. For instance, Michael Lewis got the wrong market. In "Flash Boys," he noted that the stock market is "rigged" due to high frequency trading.[3] The reality is that the market for sovereign debt has been "rigged" since 2011. For instance, during quantitative easing (QE) exercises, the Federal Reserve purchased up to 80% of the US government's fresh funding requirement. This pushed bond valuations higher – a phenomenon present in other global markets receiving QE related purchases.

Market valuations are stretched and pulled…and ready for a correction.

Be prepared: Bill White's comments regarding the best solution for crisis prevention and resolution of "be prepared" is especially relevant.[4] There is a need to war game and understand potentially adverse scenarios and pathways; map out policy responses; and put measures in place to limit risks. Bob Aliber's work is essential for all of the above, namely to contemplate shocks and resolution strategies.[5]

In early 2004, while at Treasury, I created and chaired for nearly two years an inter-agency crisis prevention group within the U.S. Government called the Financial Vulnerabilities Working

[2] Richard Sandor, "A New Bretton Woods must look to the East!," Bretton Woods 2014: Center for Financial Stability, September 3, 2014.
[3] Michael Lewis, "Flash Boys: A Wall Street Revolt," W.W. Norton & Company, Inc., 2014.
[4] William White, "The 2008 Global Financial Crisis in Retrospect," Remarks in Reykjavik, August 31, 2018.
[5] Robert Z. Aliber and Charles P. Kindleberger, Manias, Panics and Crashes, Palgrave Macmillan, Seventh Edition, 2015.

Group (VWG). The objective of the VWG was simple. We developed a Wall Street style strategy group within the U.S. government with pre-existing resources and talent. We were fortunate. A wide range of gifted and thoughtful individuals participated from 13 different agencies.

The mission was to think prospectively about factors that could threaten economic or financial stability on a global basis. As emerging market crises were fresh, we looked there. But we also looked elsewhere.

We were clear. The next crisis would likely present in the U.S. It would likely stem from housing or global imbalances. Volatility was massively mispriced due to Fed policy. Instruments were being created, similar to the unit trusts in the 1920s. Once unusually low financial market volatility reverted to its historic mean, investors would default, asset prices drop, and credit be curtailed ... creating a systemic event.[6]

Going forward, Jon Danielsson's work on perceived versus actual risk could be helpful in crisis detection and resolution.[7] Volatility is often poorly priced and understood.

Similarly, lessons learned from the Iceland financial crisis discussed over the last few days are highly applicable to many smaller open economies… experiencing capital outflows and stress e.g. Argentina, Brazil, and Turkey.

Again, many thanks are in order for Bob Aliber and Gylfi Zoega for developing and organizing such a thoughtful conference. Papers presented over the last few days coupled with action represent the best defense against future crises.

[6] Lawrence Goodman, "Crisis Detection and Prevention: Implications for Investors and Officials," Remarks at The Boston Economic Club, March 23, 2016 – http://www.centerforfinancialstability.org/speeches/Boston_032316.pdf.

[7] Jon Danielsson, "Financial policy after the crisis," Remarks in Reykjavik, August 30, 2018.