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Lessons (Not) Learned:

A Critical Review of the "Blame-it-on-the-State" Account of the Financial Crisis and its Implications for the Reform of Financial Regulation

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Summary

Since the height of the global financial crisis in the fall of 2008, an international effort to reform the operation of the financial sector has been underway. In the course of the deliberations, the initial calls for radical measures and fundamental reform have given way to more modest and limited regulatory proposals. In part, this is due to the emergence of an account that assigns the principal blame for the crisis not to the financial markets, but to ill-judged state policies. Given the implications of such an account for the future of the financial reform process, this paper reviews critically this thesis and demonstrates its weaknesses as a comprehensive account of the crisis. Accordingly, while acknowledging the progress that has already taken place, the paper argues for a strengthening of the regulatory reform effort and its re-direction towards a more fundamental reshaping of the financial system with a view to re-establishing its connection to the real economy.

Introduction

The 2007-8 financial crisis wreaked havoc to the international financial system and led to the most severe economic crisis since the interwar years. As a result, an unprecedented effort has been taking place over the past two years, at the international and European levels, to reform the financial sector in order to prevent crises of this magnitude happening again. This effort started with ambitious goals and passionate political rhetoric about the need for deep and far-reaching reform, as authorities were forced to bail out private financial institutions using taxpayers' money. However, despite the initial impetus for reform, as soon as discussions were under way, significant differences in the proposed regulatory approaches became evident. A significant factor that explains, at least partly, these disagreements, are differences in the analysis of the crisis and its underlying causes. In this respect, an influential account of the crisis gradually emerged in the months following its outbreak. This account assigns the principal blame for the financial crisis to state interventionism and ill-judged public policies, most notably in the monetary and housing policy areas. This account of the financial crisis has potentially significant consequences for the financial reform process, since it advocates very narrow and contained regulatory intervention, aimed to address a limited number of regulatory loopholes that became evident in the aftermath of the crisis.

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This paper offers a critical review of the "blame-it-on-the-state" thesis. This review aims to demonstrate that this account of the financial crisis suffers from three significant weaknesses. First, it exaggerates its point to the degree that it becomes implausible as a comprehensive explanation of the financial crisis. Secondly, it is incomplete because it focuses solely on the role of the state, ignoring the significant role of the private sector in build-up of the crisis. Thirdly, it is inconsistent because it targets specific policy choices and programmes related to "state interventionism", while leaving out of its analysis a series of other policy choices that have taken

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place over the course of the past few decades, which relate to the regulatory model employed in the financial sector, and which have on the whole diminished the role of the state in the regulation and supervision of the financial markets. As it will be argued here, these omitted parameters are far more relevant for explaining the dynamics of the financial crisis than specific choices in monetary or housing policies. Accordingly, this paper concludes with some suggestions about the direction of the financial sector reform process. It is argued that reform efforts should be strengthened, and most crucially, re-directed towards measures that seek to re-align the financial sector's interests with those of the real economy.

The State and the Financial Crisis

At the height of the crisis during the fall of 2008, the drastic and far-reaching reform of financial regulation became one of the top policy priorities at both the domestic and international levels. However, it was not long before the initial consensus for radical reform gave way to more modest and limited proposals. Among the factors that shaped this shift in tone was the emergence of a narrative of the crisis put forward by a number of academic and policy analysts that attributed the principal blame for the crisis not on the markets but on bad governmental policies. According to this account, the financial crisis was primarily the result of ill-judged, and often interventionist, public policies in certain key policy areas. Two policy areas stood out for particularly strong criticism in this respect.

The first is the area of monetary policy, and in particular the policy choices of the Federal Reserve in the United States. The main criticism is that, in deviation from its usual practice, during the first years of the decade, the Fed kept its rates too low for too long, contributing thus to the creation of a housing bubble in the United States, whose collapse sparked the crisis (Taylor 2008). If the Fed had adopted a less accommodating policy and followed more closely certain monetary policy rules (in particular the so-called "standard Taylor rule"), as it had done in the past, there would be no housing boom and therefore no bubble (Taylor 2008). No doubt, the low nominal rates of the Fed contributed to the availability of liquidity, and thus helped to create the United States' housing market bubble. However, attributing the main responsibility for the crisis to Fed's monetary policy is overstretched. While it is easy to point the finger after the fact, it is not at all clear, that US monetary authorities did anything seriously wrong. According to Bernanke (2010), the Fed's policy did follow specific monetary rules (but not the "standard" Taylor rule), while also taking into account the particular economic circumstances at the beginning of the decade ("jobless" recovery from the 2001 recession, and fear of a "Japan-style" deflationary process). Whether or not one finds this explanation convincing, the fact is that the Fed's policy the years before the crisis achieved price and output growth stability in line with its mandate (Gourinchas 2010). This undermines the validity of the critique against it, since the Fed's performance should be judged in relation to its mandate, and not in relation to the outbreak of a crisis whose handling, by its nature, is not part of the traditional monetary policy remit, and which would not have figured in the policy design of its critics either. In any case, trying to address asset price instability, with the traditional instruments of monetary policy is not easy and arguably not even desirable (Gourinchas 2010). Furthermore, the empirical record does not seem to provide strong support for the argument that the right mix of monetary policy would spare a state from the financial crisis. Germany for example, which was much closer to the standard Taylor rule, and which did not experience a housing boom, also experienced a severe banking crisis. More generally, the

global reach of the crisis, and the fact that many international banks faced problems related to the US mortgage market similar to those of US banks, demonstrate that other factors, beyond domestic monetary policy and the state of the housing market were also at play.

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The second major policy error of the state, according to its critics, is that it tried to implement social policies through the financial system, in the form of special financial institutions like Fannie Mae and Freddie Mac in the United States, and through policies such as the Bush Administration's American Dream programme, and the tax breaks for housing afforded in countries like Spain and the United Kingdom. There is no doubt that these policies contributed to the creation of housing booms in these countries. Again however, assigning most of the blame to such policies and the institutions through which they were enacted doesn't seem convincing. Take for example the role of the Government-Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac in the United States, which have been the target of heavy criticism. To begin with, if the problem was only with the practices of these institutions, then we should expect a rather limited and eventually contained crisis much like the Savings and Loans crisis of the 1980s, and not the global financial meltdown that we have experienced. In any event, these organizations do not give out mortgages per se. Rather, their role is to provide liquidity in the secondary mortgage market. Therefore, attributing the principal blame on them for the explosion in subprime lending doesn't make much sense. Neither their engagement in the securitization of subprime mortgages, which presumably encouraged private institutions to issue more subprime loans, was as important as their critics claim. In fact, as a recent report by the Federal Housing Finance Agency (FHFA), documents, private-label issuers played the principal role in securitizing higher-risk mortgages from early 2004 to mid-2007, while the GSEs continued to guarantee primarily traditional mortgages (FHFA 2010).

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In sum, one can certainly argue that particular policy choices have contributed to the crisis, directly or indirectly. However, attributing most of the blame to these policies after the fact is both implausible and unfair. Beyond the specifics of the criticisms reviewed above, a more general consideration that seems to be ignored by the critics, are the effects of their proposed solutions beyond the narrow limits of their policy target (in this case the prevention of a housing bubble), as well as the wider political framework within which such policies are decided. For example, it is not clear what would be the consequences of a tight monetary policy (as the critics would have liked to see), on economic activity during a period of low inflation and stable output growth. Certainly one has to question whether it would have been politically feasible for the Fed to adopt such a policy at the time. Similarly, in the case of housing policy, it should be reminded that policies that support home-ownership among the less privileged classes of the population are designed to fulfil not only economic policy objectives, but wider political objectives related to concepts of social justice and inclusion. Therefore, while there may be a case to be made for a rethink of the way they are designed and implemented, the desirability of such policies cannot be decided solely on the grounds of their effect on the financial system.

The Private Financial Sector and the Crisis

From above, it becomes evident that the "blame-it-on-the-state" narrative leaves out a significant part of the story, namely the role of private financial institutions. Most analysts agree that the immediate cause of the crisis was the uncontrollable expansion of securitization activities that, to a large extent,

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took place through an opaque "shadow banking" system that grew in the years before the crisis, and which increased the leverage of the financial sector to unsustainable levels (Blundell-Wignall et al. 2008; Acharya and Richardson 2009). Securitization is the process through which loans are parcelled and sold to investors. Securitization is supposed to reduce the risk of the original lender by spreading the credit risk associated with the loans to a wide array of investors, thereby also reducing the overall risk of the financial system, as risk is more widely dispersed. However, in the years before the crisis, securitization operated in a perverse way that ended up not dispersing, but concentrating risk in commercial and investment banks. This happened because banks, instead of selling securitized assets to other investors decided to hold them on their balance sheets, or to keep them in off-balance sheet entities. Moreover, the securities that the banks held, were of increasingly lower quality, subprime mortgage-backed securities being a prime example, but structured in such a way (for example by having different tranches), that allowed, at least part of them, to be rated as AAA securities. By holding these securities either in off-balance sheet entities, or by repackaging them as AAA-rated securities, banks were able to manipulate regulatory requirements, limiting the capital they were required to hold, while simultaneously increasing manifold their leverage, and consequently their earnings.

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Critics argue that these developments refer only to symptoms of the crisis and not its true causes. That may be true, but then, this means that one should search for the real causes not in governmental policies, but rather in the incentives that guided the conduct of private financial institutions. As noted by the authors of an OECD report on the causes of the crisis, these incentives were the result of a changing business model in the financial sector, whereby the traditional role of the financial intermediaries, founded on providing the essential service of matching the flows of funds between savers and borrowers to the benefit of the real economy, was replaced by an equity culture focused on share price performance and high earnings (Blundell-Wignall et al. 2008). This resulted in perverse incentives, as compensation schemes followed this re-orientation and led managers to focus on easy, short-term profits, without taking due notice of the underlying risks of their practices, or the long-term consequences for their institutions.

It is clear that it is not possible to exonerate financial actors of their individual responsibility, by blaming only bad governmental policies for setting the stage for the crisis. Neither is it possible to brush aside such criticism as superficial, because it relates to "unscientific" concepts such as greed. Some of the most interesting and policy relevant developments in financial economics in recent years actually focus on human behaviour, and have shown that economic actors can act irrationally, propelled by cognitive biases, fallacies and personal impulses. Surely, one cannot argue that it was some ill-thought governmental policy, and not the short-sighted and irresponsible behaviour of its management, that led Lehman Brothers to have an unsustainable balance sheet at the end of 2007, where approximately 80% of its total liabilities were of a short-term nature, much of it in the form of overnight repos, or on-demand payable cash deposits from hedge funds, and where cash holdings were about $7 billion, in a balance sheet the size of $691 billion.

The call for serious and dispassionate analysis is a crucial one, but the argument cuts both ways. Arguments that seek to exonerate the financial industry of wrong-doing can be every bit as superficial, or naive as popular

condemnations of "evil" bankers. For example, it truly seems far-fetched to argue, as Jeffrey Friedman (2009) has done, that human ignorance and not intentional wrong-doing, was the main cause for the bankers' behaviour. Although ignorance certainly explains part of the excesses witnessed the years before the crisis, exonerating bankers from any intentional wrong-doing, is very hard to accept. One cannot really believe that highly qualified and experienced senior managers never questioned the fact that they were enjoying very high returns, of the kind usually associated with securities of the junk bond variety, by securities that were assigned a triple-A rating. As any first-year economics student would know, high returns are compensation for high risk. Besides, as Friedman himself acknowledges, there were other banks that performed a proper analysis of the risks associated with these securities and chose to stay away. This means that the signs were there for anyone willing to see. The fact that some chose to turn a blind eye cannot pass for ignorance.

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Financial Regulation and the Crisis

The discussion above notwithstanding, it is not only financial markets that have to bear the blame for the crisis. Bad governmental choices were crucial for the formation of the adverse incentives in the private sector and contributed to the creation of an environment conducive to a crisis. However, these choices have less to do with the monetary and social policies of states, and more with their regulatory choices in the financial sector during the past three decades. What almost all the regulatory initiatives in this issue-area have in common is that they mandated a "softer", market-based approach to regulation. Moreover, national reforms were complemented by a series of international regulatory initiatives that sought to extend geographically and embed institutionally the principles of the new regulatory approach. In this context, the financial sector has been re-regulated along a rationale that seeks to promote the growth of financial markets (in order to make them more efficient), and to substitute market mechanisms for public regulations.

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Thus, for example, in the United States this approach dismantled safety valves, such as the Glass-Steagall Act which separated commercial from investment banking, and "levelled" the playing field by relaxing the supervisory framework for investment banks, thereby leading to the replacement of a 15:1 leverage ratio rule, with a regulatory framework that allowed ratios that could reach 40:1, from 2004 onwards (Blundell-Wignall et al. 2008). In a similar vein, in the United States, but also in countries like the United Kingdom and Germany, minimal capital requirements for off-balance sheet entities, allowed major banks in these countries to invest heavily in a variety of high-risk asset-backed securities through an array of structured investment vehicles (SIVs), creating a "shadow banking" system that effectively operated without any regulatory supervision (Acharya and Richardson 2009). Internationally, regulatory developments include the increased regulatory reliance on the ratings of the private credit rating agencies, the new Basle II banking framework, which effectively allowed major financial institutions to measure their own risk, the tolerance of the explosion of business in the "over-the-counter" (OTC) derivatives market, which operated outside of all regulatory and supervisory control, and the promotion of the "fair value" accounting approach, which increased substantially the pro-cyclicality of the entire system, while also proving inoperable in circumstances of distressed markets.

These developments in the regulatory model of the financial sector at both the national and international levels are far more relevant for understanding both the conduct of

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private financial institutions, and the regulators' failure to diagnose in time, and react effectively to prevent the crisis. According to this analysis then, and contrary to the critics' denunciations, it isn't the interventionism of state authorities that has to figure as one of the principal underlying factors of the crisis, but rather the lack of it, that is, their failure to regulate and supervise adequately their financial systems. More generally, this crisis has undermined the validity of the market-based regulation doctrine. The practices of the financial markets' actors the years before the crisis has shown that the ability of market competition to lead to more efficient and secure financial markets is far from guaranteed. When information is incomplete and incentives are skewed, competition can very easily lead to imitative and herding behaviour, phenomena which were evident during the built-up of the crisis. Indeed, short-termism and imitative behaviour, combined with lax regulatory control and oversight, can help us explain with considerable precision particular aspects of the crisis. For example, as was noted before, big commercial banks in a number of countries sponsored off-balance sheet entities in order to avoid retaining high levels of regulatory capital. These banks were found in countries that had very different monetary and housing policies. What these countries did have in common though, were banks that sought to replicate the easy earnings they saw others enjoy through the shadow banking system, and lax regulation and supervision. What they also had in common, once the crisis broke, were huge public bailouts of these same banks.

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Reform of the International Financial System

This paper has sought to reveal the weaknesses of a monolithic and ultimately unsatisfactory account of the financial crisis that aims to assign the principal blame for the crisis to the state. Certainly, the state has to bear part of the blame for the crisis. However, the fault with state authorities lies not with their choice of ill-designed policies, or their endorsement of intrusive state programmes, but rather with their abstention from their regulatory and supervisory duties before the crisis. The resulting market-based regulatory framework, in the context of globalizing financial markets and increasingly complex financial innovation, have progressively led to the creation of an international financial system whose workings have less to do with the funding needs of the global economy, and more with the pursuit of easy, short-term earnings through the design of a complex web of financial instruments, which, to a significant degree operates isolated and disengaged from developments in the real economy.

State authorities should not repeat the same mistake twice. Although intense lobbying has already watered down many of the proposed reforms, the effort should not be abandoned. Already, some important changes have been agreed at the national, regional and international levels. For example, the Dodd-Frank Act in the United States has introduced significant reforms, including the constraint of proprietary trading by banks (the so-called "Volcker rule"), while the European Union has engaged in a wide-ranging reform process which has introduced regulation for credit rating agencies and hedge funds for the first time, and has stipulated the migration of a significant part of derivatives' transactions to organized exchanges and their centralized clearing. At the same time, the new capital rules agreed by the Basle Committee are encouraging.

These measures are positive and will no doubt contribute to a more efficient and stable international financial system, although, in their current form, and in the context of the current institutional framework, may not be enough, as there are ways to circumvent them. More

generally, the dilemma that confronts state authorities is whether they will opt for a reform or an update of the current regulatory model. In the view of the author of this paper, what is needed is reform that has to go beyond the cover-up of loopholes discovered in the aftermath of the crisis. The remedy to an, ultimately unsatisfactory, never-ending regulatory catch-up process (as it is certain that financial innovation will create new loopholes in the future) is to push through more radical reforms that redirect the financial sector, or at least part of it, towards its more fundamental economy-supporting role. The rationale here is to go beyond the regulation of specific institutions and move towards the regulation of financial functions, with the aim of safeguarding those that are crucial for the real economy. An influential proposal along these lines is John Kay's "narrow banking" proposal, which advocates the separation of risky investment-related activities of banks, from their more traditional, and crucial for the economy, business of deposit-taking, working capital and productive-investment funding, and payments services. In such a set-up only "narrow banks" would enjoy government protection, while risky investment and trading business would not be protected by government guarantees, regardless of its size. In this market, *caveat emptor* should be the rule: after all, if one chooses to trade in "hot air" they should expect that they might get burnt. Moreover, the risky and speculative invesment business should be subject to regulatory interventions such as a "transaction tax" (so-called Tobin tax) for short-term cross-border transactions, and/or restrictions on trading in certain areas crucial for the world economy (for example commodities). The usual critique of such proposals is that they are too buderdsome and complicated to implement in practice. This is not a convincing argument, since financial institutions have rapidly and repeatedly transformed their operations in recent years in order to exploit developments in financial innovation and international markets. The difference (and the real reason behind financial instituions' disagreement) is that these previous changes were adopted in order to participate in new profit-making business, whereas the proposed changes would entail the shedding of such activities for the institutions chosing to retain the bank label. There is no doubt that the design of public regulation should always take into account its potential costs in terms of both implementation and sacrificed efficiency gains. Without discounting the substantial costs associated with the implementation of such proposals, it is certain that these pale in comparison with the economic and social costs produced by the crisis. It is these wider economic and social costs, and not only the operational costs of the financial sector that we should take into account when considering the reform of financial regulation. Indeed, it is for this reason that this kind of fundamental reform proposals have been endorsed by a number of serious analysts and policy-makers, not least, by Mervyn King, the Governor of the Bank of England, who has recently argued in favour of more radical solutions than those hitherto approved by the Basle Committee (King 2010).

Despite, or rather because of the devastation it has caused, this crisis presents a rare opportunity to rethink fundamentally the operation of the financial system. Corporate lobbying, and pro-market protests based on ideology and fear of regulatory overkill, should not be allowed to derail the reform effort. Unless fundamental reform is undertaken, the next financial crisis might be closer than we think.

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