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Comments on Reforming the Financial Sector
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For a Restructure of the Financial System

My understanding of the crisis (and maybe others') has built up layer by layer. One layer is the lessons of my structuralist models from the 1990s. When the speculative vision is seen to be a mirage, the asset prices drop back. Yet the stocks of the various assets remain somewhat *elevated* relative to their starting point and, as a result, so are the real prices of the assets (!).[2] Then the stocks and their real prices slowly shrink to their normal level. Gross investment activity (and employment) may be *elevated* too (but not enough to prevent declining stocks), owing to the elevation of assets' real prices, though receding, or may be *depressed*, owing to the increased wealth people own, though recovering as assets and wealth sink back to normal. Whichever is the case, I don't see this as a tragedy!

In another structuralist story – aspects of which I later worked on with Amar Bhidé – China embraces a sort of state capitalism, whereupon its productivity climbs steeply – far ahead of the absorption capacities of consumption demand and investment demand; so imports lag behind exports. This imbalance is met with jubilation in America, where the prospect of an era of low world real interest rates launches the general level of asset prices on an upward path toward heretofore unseen levels and triggers boom in the favored industries. This story is no tragedy either.

But why has the end of the recent boom been so destructive? And why is there a widely held sense that no return to high prosperity is in prospect? Answering these questions requires another layer of explanation.

Last summer I saw the possibility of one answer. The "uncertainty premium" drives a wedge between the value placed on another unit of the asset and the cost of its production; and an increase of the premium widens the wedge, thus contracting the "natural" level of employment.[3] And much of the uncertainty springs from the indebtedness of households and banks, which has put them in a precarious position.

•A great many people borrowed to the hilt, taking advantage of the extraordinarily attractive terms that became available, in order to own their home or a bigger home or a second home. Some speculators simply wanted to buy a house or two or even more in the expectation that the capital gains would more than compensate for tying up their capital in a down payment. By 2007 household debt was a whopping 100% of the GDP that year. In taking on so very much debt, American households were making themselves extremely vulnerable to economic distress in the event that housing prices suffered the correction that occurred – one that many economists (including Bob Aliber and Bob Shiller) were forecasting.

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[2] The rise in the housing stock *decreases* the price of housing services relative to the nominal price of houses, thus to *increase* the relative price of houses – that is, the *real* prices of houses.
[3] "A View of Monetary Policy From Our 'Structuralist' and Uncertain Economies," 7th Annual BIS Conference on Monetary Policy, Luzern, June 26-27, 2008.

•The banks also borrowed massive amounts, leveraging an essentially unchanged amount of capital, in order to acquire massive loans and other assets. The gross debt of the financial sector rose to 117% of GDP in the third quarter of 2008. Thus the banks made themselves extremely vulnerable to the correction of housing prices that occurred. With the fall of asset prices, many of the banks are nearly insolvent. They cannot raise more capital without extreme dilution, and have no appetite for making added loans, which would add to their precariousness.

But what explains the huge rise of indebtedness? A part of the puzzle is explained by Leo Tilman's book *Financial Darwinism.* The influx of capital into the U.S. looking for returns, in driving asset prices up and interest rates down, made it impossible for the typical bank, commercial or investment-type, to hit its target rate of return. It responded by "reaching for return," as James Tobin used to put it – by borrowing more in order to lend more, thus leveraging its capital. But as all banks increased their leverage, asset prices were driven higher. The banks were chasing their tail. I think there was little or no share price appreciation in real terms at U.S. banks between, say, 1999 and 2007. (This runs contrary to the impression that the banks were making tremendous rates of return. They were making reduced rates on assets having higher prices, so profits rose.)

I suggest that Washington played a pervasive role as well through its actions and its influence on social fashion. Legislation and government pressure managed to increase an important increase in the supply of credit for housing.

•Until 1997 the "rollover" law exempted those selling their homes from capital gains tax provided they purchased another, more expensive home in the allotted time. The subsequent Taxpayers Relief Act of 1997 excluded the first $500,000 from the capital gains tax on a home held and lived in for 2 of the last 5 years. This invited people to buy a home on the speculation that they could flip it within 2 years and exclude the $500,000.

•The federal government put unmistakable pressure on banks to expand their residential mortgage lending.

•Fannie May and Freddie Mac, established to buy residential mortgages, were pressured by Congressional leaders to ramp up their purchases – no matter the risks that would seem to have posed for the investors, such as China. Later, the investors were given to believe that their holdings were guaranteed, so as to hold down the cost of capital for Fannie May and Freddie Mac.

I would argue also that the fashion in the present decade for more and better and bigger houses stimulated an increase in demand for houses – beyond that produced by the worldwide decline in real interest rates – and an increase in demand for credit to help finance the purchases.

•In the wake of 9/11, President Bush urged American households to step up their consumption spending. The argument was that increased spending is good for employment and will be repaid with increased income – Keynes's paradox of thrift. No actual decline of wealth will have to be incurred! Franklin's "a penny saved is a penny earned" was replaced by "a penny spent is a penny earned."

•A year or two later, the executive branch, in connection with the re-election campaign if I am not mistaken, promulgated the concept of an "ownership society." That did not mean owning stocks and bonds so much as it meant – at least for most people – owning your own home.

•Recently, the political movement achieved the final articulation of its goal. Coolidge famously said that "the chief business of America is business" and that was true from the early settlers to well into the 20th century. What came to be called the American Dream was a successful and rewarding career – "making it" in the sense of making a high enough salary to pay for the primary goods, to have economic independence, but also a having a career of meeting challenges, taking initiative and exploring for new possibilities. Washington somehow managed to change the American Dream to Home Ownership.

Both the home ownership craze and the push on the financial sector to supply more credit for home buying operated to divert some of the world's capital from U.S. business, where it would have gone, into housing. Susan Lee (2008) recalls a book by Edwin Mills (1987) arguing that the GDP would be 5% to 10% higher if capital were to be allocated neutrally between housing and business.

Yet another effect, as Amity Shlaes and I argued in one of her Bloomberg columns (2007), is that an additional housing stock lessens the mobility of labor. Still another effect is that occupant ownership – or owner occupancy – is an impediment if not a barrier to widescale community improvement, as shown years ago by Andrew Winston and Otto Davis (1962).

Finally, there is the effect on dynamism. It is a fact that in the 1990s, innovation, such as it was, depended largely on the meager capital of a small heroic band of angel investors and venture capitalists. Nevertheless, there were 350 initial public offerings per year in the 1990s. Now, in the 2000s, the fires of innovation have been dying down. The number of IPOs per year in the 2006 has been only 50 per annum. Perhaps the housing boom did not wholly cause the shift of capital away from innovation. However, the housing boom, in drawing some capital into housing that would otherwise have gone into venture capital and hedge funds, must have done some damage to the dynamism of the economy – thus to the rate of innovation.

The crucial task starting now, in 2009, before it is too late, will be to restructure, or reconfigure, the financial sector so that it becomes less of a conduit for mortgage lending for residential and commercial construction – and more a set of well-functioning institutions with the expertise to make lending decisions for business investment and business innovation!

This is urgent, since what the government seems to want now is to restore not just construction activity in the housing industry but to restore the previous role that the entire housing market played in the lives of consumers and, in turn, Wall Street.

I am not the right economist to say precisely how this is best done. But I do have the “vision thing.” U.S. housing has banks dedicated to it that were set up by the U.S. government. Agriculture also has a network of dedicated banks serving the financing needs of farmers. It would be harder to dismantle those aids to particular factions in America than to set up a counterweight. The government could sponsor the creation of financial companies of a new kind: regional or state-wide banks dedicated to serving the business sector – particularly the needs for finance of long-term investment and innovation.

We might do well to model a new class of banks – financial entities, if you prefer – after the investment banks of the 1870s, such as Deutsche Bank. “In the 1880s and 1890s it played a major part in the development of Germany’s electrical-engineering industry.” (Company history, p.2.) It became a lender to the Edison Company in those years.

It may be that the political forces behind Home Ownership will aim to “put Humpty Dumpty together again.” Yet perhaps we can persuade them to strike out in the new direction I have sketched here.

Thank you.